

CULLEN FROST BANKERS INC

Form 10-Q

October 22, 2008

[Table of Contents](#)

United States Securities and Exchange Commission

Washington, D.C. 20549

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, 2008

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: 001-13221

Cullen/Frost Bankers, Inc.

(Exact name of registrant as specified in its charter)

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

Texas
(State or other jurisdiction of incorporation or organization)

74-1751768
(I.R.S. Employer Identification No.)

100 W. Houston Street, San Antonio, Texas
(Address of principal executive offices)

78205
(Zip code)

(210) 220-4011

(Registrant's telephone number, including area code)

N/A

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

As of October 16, 2008, there were 59,322,913 shares of the registrant's Common Stock, \$.01 par value, outstanding.

Table of Contents

Cullen/Frost Bankers, Inc.

Quarterly Report on Form 10-Q

September 30, 2008

Table of Contents

| | Page |
|--|-------------|
| <u>Part I - Financial Information</u> | |
| Item 1. <u>Financial Statements (Unaudited)</u> | |
| <u>Consolidated Statements of Income</u> | 3 |
| <u>Consolidated Balance Sheets</u> | 4 |
| <u>Consolidated Statements of Changes in Shareholders' Equity</u> | 5 |
| <u>Consolidated Statements of Cash Flows</u> | 6 |
| <u>Notes to Consolidated Financial Statements</u> | 7 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 23 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 45 |
| Item 4. <u>Controls and Procedures</u> | 46 |
| <u>Part II - Other Information</u> | |
| Item 1. <u>Legal Proceedings</u> | 47 |
| Item 1A. <u>Risk Factors</u> | 47 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 47 |
| Item 3. <u>Defaults Upon Senior Securities</u> | 47 |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u> | 47 |
| Item 5. <u>Other Information</u> | 47 |
| Item 6. <u>Exhibits</u> | 47 |
| <u>Signatures</u> | 48 |

Table of Contents**Part I. Financial Information****Item 1. Financial Statements (Unaudited)
Cullen/Frost Bankers, Inc.****Consolidated Statements of Income**

(Dollars in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|----------------|--|----------------|
| | 2008 | 2007 | 2008 | 2007 |
| Interest income: | | | | |
| Loans, including fees | \$ 125,446 | \$ 145,106 | \$ 379,164 | \$ 432,607 |
| Securities: | | | | |
| Taxable | 35,233 | 35,675 | 109,234 | 110,271 |
| Tax-exempt | 5,632 | 4,706 | 16,411 | 11,798 |
| Interest-bearing deposits | 21 | 99 | 141 | 272 |
| Federal funds sold and resell agreements | 344 | 9,288 | 3,284 | 25,529 |
| Total interest income | 166,676 | 194,874 | 508,234 | 580,477 |
| Interest expense: | | | | |
| Deposits | 23,218 | 49,441 | 83,462 | 146,897 |
| Federal funds purchased and repurchase agreements | 2,976 | 7,981 | 10,954 | 24,453 |
| Junior subordinated deferrable interest debentures | 1,537 | 2,548 | 5,234 | 8,740 |
| Subordinated notes payable and other borrowings | 4,209 | 4,280 | 12,640 | 12,410 |
| Total interest expense | 31,940 | 64,250 | 112,290 | 192,500 |
| Net interest income | 134,736 | 130,624 | 395,944 | 387,977 |
| Provision for possible loan losses | 18,940 | 5,784 | 29,273 | 11,084 |
| Net interest income after provision for possible loan losses | 115,796 | 124,840 | 366,671 | 376,893 |
| Non-interest income: | | | | |
| Trust fees | 19,749 | 17,749 | 57,071 | 52,350 |
| Service charges on deposit accounts | 22,642 | 20,696 | 63,869 | 59,674 |
| Insurance commissions and fees | 8,261 | 7,695 | 26,434 | 24,868 |
| Other charges, commissions and fees | 10,723 | 10,772 | 27,150 | 24,609 |
| Net gain (loss) on securities transactions | 78 | | (26) | |
| Other | 15,862 | 13,844 | 43,626 | 40,347 |
| Total non-interest income | 77,315 | 70,756 | 218,124 | 201,848 |
| Non-interest expense: | | | | |
| Salaries and wages | 57,803 | 52,996 | 167,475 | 155,913 |
| Employee benefits | 10,677 | 10,727 | 36,702 | 37,150 |
| Net occupancy | 10,342 | 9,509 | 30,080 | 28,626 |
| Furniture and equipment | 9,657 | 8,793 | 27,789 | 23,951 |
| Intangible amortization | 1,976 | 2,184 | 5,977 | 6,698 |
| Other | 32,517 | 29,358 | 95,079 | 95,958 |

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

| | | | | |
|---|-----------|-----------|------------|------------|
| Total non-interest expense | 122,972 | 113,567 | 363,102 | 348,296 |
| Income before income taxes | 70,139 | 82,029 | 221,693 | 230,445 |
| Income taxes | 21,174 | 25,566 | 67,401 | 73,074 |
| Net income | \$ 48,965 | \$ 56,463 | \$ 154,292 | \$ 157,371 |
| Earnings per common share: | | | | |
| Basic | \$ 0.83 | \$ 0.97 | \$ 2.63 | \$ 2.66 |
| Diluted | 0.82 | 0.95 | 2.61 | 2.62 |
| See Notes to Consolidated Financial Statements. | | | | |

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Balance Sheets**

(Dollars in thousands, except per share amounts)

| | September 30, 2008 | December 31, 2007 | September 30, 2007 |
|--|-----------------------|----------------------|-----------------------|
| Assets: | | | |
| Cash and due from banks | \$ 944,214 | \$ 836,539 | \$ 608,336 |
| Interest-bearing deposits | 4,547 | 5,898 | 8,727 |
| Federal funds sold and resell agreements | 180,026 | 354,075 | 556,652 |
| Total cash and cash equivalents | 1,128,787 | 1,196,512 | 1,173,715 |
| Securities held to maturity, at amortized cost | 7,144 | 8,125 | 8,550 |
| Securities available for sale, at estimated fair value | 3,170,655 | 3,407,012 | 3,446,752 |
| Trading account securities | 25,371 | 11,913 | 10,779 |
| Loans, net of unearned discounts | 8,595,986 | 7,769,362 | 7,460,755 |
| Less: Allowance for possible loan losses | (107,109) | (92,339) | (92,263) |
| Net loans | 8,488,877 | 7,677,023 | 7,368,492 |
| Premises and equipment, net | 248,419 | 219,615 | 217,332 |
| Goodwill | 526,876 | 526,851 | 528,491 |
| Other intangible assets, net | 26,579 | 31,523 | 31,782 |
| Cash surrender value of life insurance policies | 119,974 | 116,231 | 115,082 |
| Accrued interest receivable and other assets | 318,802 | 290,209 | 265,706 |
| Total assets | \$ 14,061,484 | \$ 13,485,014 | \$ 13,166,681 |
| Liabilities: | | | |
| Deposits: | | | |
| Non-interest-bearing demand deposits | \$ 3,817,314 | \$ 3,597,903 | \$ 3,602,780 |
| Interest-bearing deposits | 6,800,906 | 6,931,770 | 6,493,052 |
| Total deposits | 10,618,220 | 10,529,673 | 10,095,832 |
| Federal funds purchased and repurchase agreements | 1,286,449 | 933,072 | 893,266 |
| Subordinated notes payable and other borrowings | 256,581 | 261,146 | 261,202 |
| Junior subordinated deferrable interest debentures | 136,084 | 139,177 | 139,177 |
| Accrued interest payable and other liabilities | 153,290 | 144,858 | 390,483 |
| Total liabilities | 12,450,624 | 12,007,926 | 11,779,960 |
| 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 issued at each period end | | | |
| Additional paid-in capital | 602 | 602 | 602 |
| Retained earnings | 589,010 | 573,799 | 572,421 |
| Accumulated other comprehensive income (loss), net of tax | 1,053,129 | 992,138 | 966,312 |
| Treasury stock, 937,447 shares, 1,574,732 shares and 1,813,461 shares, at cost | 17,771 | (7,382) | (58,018) |
| | (49,652) | (82,069) | (94,596) |

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

| | | | |
|--|---------------|---------------|---------------|
| Total shareholders' equity | 1,610,860 | 1,477,088 | 1,386,721 |
| Total liabilities and shareholders' equity | \$ 14,061,484 | \$ 13,485,014 | \$ 13,166,681 |

See Notes to Consolidated Financial Statements.

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Statements of Changes in Shareholders' Equity**

(Dollars in thousands, except per share amounts)

| | Nine Months Ended September 30, | |
|--|--|---------------------|
| | 2008 | 2007 |
| Total shareholders' equity at beginning of period | \$ 1,477,088 | \$ 1,376,883 |
| Cumulative effect of adoption of a new accounting principle on January 1, 2008 (Note 18) | (240) | |
| Comprehensive income: | | |
| Net income | 154,292 | 157,371 |
| Other comprehensive income: | | |
| Change in accumulated gain/loss on effective cash flow hedging derivatives of \$34,937 in 2008 and \$582 in 2007, net of tax effect of \$12,228 in 2008 and \$204 in 2007 | 22,709 | 378 |
| Change in unrealized gain/loss on securities available for sale of \$2,813 in 2008 and \$(7,382) in 2007, net of reclassification adjustment of \$26 in 2008 and tax effect of \$994 in 2008 and \$(2,584) in 2007 | 1,845 | (4,798) |
| Change in funded status of defined benefit post-retirement benefit plans related to the amortization of actuarial losses to net periodic benefit cost of \$922 in 2008 and \$1,991 in 2007, net of tax effect of \$323 in 2008 and \$697 in 2007 | 599 | 1,294 |
| Total other comprehensive income (loss) | 25,153 | (3,126) |
| Total comprehensive income | 179,445 | 154,245 |
| Stock option exercises (1,041,600 shares in 2008 and 680,534 shares in 2007) | 34,469 | 18,523 |
| Stock compensation expense recognized in earnings | 7,435 | 7,471 |
| Tax benefits related to stock compensation, includes excess tax benefits of \$7,231 in 2008 and \$6,231 in 2007 | 7,776 | 6,382 |
| Purchase of treasury stock (404,315 shares in 2008 and 2,096,277 shares in 2007) | (21,918) | (109,423) |
| Cash dividends (\$1.24 per share in 2008 and \$1.14 per share in 2007) | (73,195) | (67,360) |
| Total shareholders' equity at end of period | \$ 1,610,860 | \$ 1,386,721 |

See Notes to Consolidated Financial Statements.

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Statements of Cash Flows**

(Dollars in thousands)

| | Nine Months Ended September 30, | |
|--|--|----------------|
| | 2008 | 2007 |
| Operating Activities: | | |
| Net income | \$ 154,292 | \$ 157,371 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Provision for possible loan losses | 29,273 | 11,084 |
| Deferred tax expense (benefit) | (5,359) | 231 |
| Accretion of loan discounts | (9,171) | (9,750) |
| Securities premium amortization (discount accretion), net | 529 | (1,644) |
| Net (gain) loss on securities transactions | 26 | |
| Depreciation and amortization | 24,650 | 23,031 |
| Origination of loans held for sale | (34,949) | (71,647) |
| Proceeds from sales of loans held for sale | 66,388 | 49,911 |
| Net gain on sale of loans held for sale and other assets | (2,340) | (1,059) |
| Stock-based compensation expense | 7,435 | 7,471 |
| Tax benefit from stock-based compensation | 545 | 151 |
| Excess tax benefits from stock-based compensation | (7,231) | (6,231) |
| Earnings on life insurance policies | (3,743) | (3,340) |
| Net change in: | | |
| Trading account securities | (13,458) | (1,373) |
| Accrued interest receivable and other assets | (1,251) | (6,124) |
| Accrued interest payable and other liabilities | 15,411 | 32,515 |
| Net cash from operating activities | 221,047 | 180,597 |
| Investing Activities: | | |
| Securities held to maturity: | | |
| Maturities, calls and principal repayments | 978 | 1,541 |
| Securities available for sale: | | |
| Purchases | (3,287,822) | (8,191,457) |
| Sales | 888,295 | 14,443 |
| Maturities, calls and principal repayments | 2,638,171 | 8,254,107 |
| Net change in loans | (871,391) | (74,584) |
| Net cash paid in acquisitions | (229) | (1,903) |
| Proceeds from sales of premises and equipment | 1,284 | 4,473 |
| Purchases of premises and equipment | (43,711) | (18,881) |
| Proceeds from sales of repossessed properties | 4,800 | 5,282 |
| Net cash from investing activities | (669,625) | (6,979) |
| Financing Activities: | | |
| Net change in deposits | 88,547 | (292,077) |
| Net change in short-term borrowings | 353,377 | 29,076 |
| Proceeds from notes payable | | 98,799 |
| Principal payments on notes payable and other borrowings | (7,658) | (128,257) |
| Proceeds from stock option exercises | 34,469 | 18,523 |
| Excess tax benefits from stock-based compensation arrangements | 7,231 | 6,231 |
| Purchase of treasury stock | (21,918) | (109,423) |
| Cash dividends paid | (73,195) | (67,360) |

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

| | | |
|---|---------------------|---------------------|
| Net cash from financing activities | 380,853 | (444,488) |
| Net change in cash and cash equivalents | (67,725) | (270,870) |
| Cash and equivalents at beginning of period | 1,196,512 | 1,444,585 |
| Cash and equivalents at end of period | \$ 1,128,787 | \$ 1,173,715 |
| Supplemental disclosures: | | |
| Cash paid for interest | \$ 124,838 | \$ 196,787 |
| Cash paid for income taxes | 64,965 | 60,517 |
| See Notes to Consolidated Financial Statements. | | |

Table of Contents

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, trust and investment management, mutual funds, investment banking, insurance, brokerage, leasing, asset-based lending, treasury management and item processing.

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, 2007, included in the Corporation's Annual Report on Form 10-K filed with the SEC on February 1, 2008 (the 2007 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.

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, 2008 and 2007 is reported in the accompanying consolidated statements of changes in shareholders' equity. The Corporation had comprehensive income of \$81.7 million and \$85.9 million for the three months ended September 30, 2008 and 2007. Comprehensive income during the three months ended September 30, 2008 and 2007 included net after-tax gains of \$12.7 million and \$28.5 million due to decreases in the net unrealized loss on securities available for sale. Comprehensive income during the three months ended September 30, 2008 also included net after-tax gains of \$19.8 million due to changes in the accumulated gain/loss on cash flow hedging derivatives.

Fair Value Measurements. On January 1, 2008, the Corporation adopted Statement of Financial Accounting Standards (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 (See Note 17 - Fair Value Measurements).

Endorsement Split-Dollar Life Insurance Arrangements. On January 1, 2008, the Corporation changed its accounting policy and recognized a cumulative-effect adjustment to retained earnings totaling \$240 thousand related to accounting for certain endorsement split-dollar life insurance arrangements in connection with the adoption of Emerging Issues Task Force (EITF) Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements*. See Note 18 - New Accounting Standards.

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

Table of Contents

Note 2 Mergers and Acquisitions

The Corporation acquired R.G. Seeberger Company, Inc. (Seeberger), an independent, Dallas-based insurance agency on July 1, 2008 and Prime Benefits, Inc. (Prime Benefits) an independent, Austin-based insurance agency on December 1, 2007. Seeberger and Prime Benefits, which both specialized in group employee benefits plans, were fully integrated into Frost Insurance Agency subsequent to acquisition. The acquisitions were accounted for as purchase transactions with all cash consideration funded through internal sources. The operating results of each company are included with the Corporation's results of operations since their respective dates of acquisition. The purchases of Seeberger and Prime Benefits did not significantly impact the Corporation's financial statements.

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, 2008 | | | | December 31, 2007 | | | |
|---|--------------------|------------------------------|-------------------------------|-------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
| | 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 | \$ 6,144 | \$ 89 | \$ 4 | \$ 6,229 | \$ 7,125 | \$ 103 | \$ 14 | \$ 7,214 |
| Other | 1,000 | | | 1,000 | 1,000 | | | 1,000 |
| Total | \$ 7,144 | \$ 89 | \$ 4 | \$ 7,229 | \$ 8,125 | \$ 103 | \$ 14 | \$ 8,214 |
| Securities Available for Sale: | | | | | | | | |
| U.S. Treasury | \$ 24,942 | \$ 44 | \$ | \$ 24,986 | \$ | \$ | \$ | \$ |
| U.S. government agencies and corporations | 2,569,722 | 16,254 | 10,656 | 2,575,320 | 2,865,597 | 9,756 | 30,042 | 2,845,311 |
| States and political subdivisions | 556,231 | 1,600 | 25,349 | 532,482 | 524,745 | 3,040 | 3,700 | 524,085 |
| Other | 37,867 | | | 37,867 | 37,616 | | | 37,616 |
| Total | \$ 3,188,762 | \$ 17,898 | \$ 36,005 | \$ 3,170,655 | \$ 3,427,958 | \$ 12,796 | \$ 33,742 | \$ 3,407,012 |

Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost and are reported as other available for sale securities in the table above.

Securities with a carrying value totaling \$2.4 billion at September 30, 2008 and \$2.2 billion at December 31, 2007 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, | |
|-----------------------|-------------------------------------|--------|------------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Proceeds from sales | \$ 32,100 | \$ 603 | \$ 888,295 | \$ 14,443 |
| Gross realized gains | 83 | | 5,917 | |
| Gross realized losses | 5 | | 5,943 | |

As of September 30, 2008, securities, with unrealized losses segregated by length of impairment, were as follows:

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

| | Less than 12 Months | | More than 12 Months | | Total | |
|---|---------------------|------------|---------------------|------------|--------------|------------|
| | Estimated | Unrealized | Estimated | Unrealized | Estimated | Unrealized |
| | Fair Value | Losses | Fair Value | Losses | Fair Value | Losses |
| Held to Maturity | | | | | | |
| U.S. government agencies and corporations | \$ 1,998 | \$ 4 | \$ 22 | \$ | \$ 2,020 | \$ 4 |
| Total | \$ 1,998 | \$ 4 | \$ 22 | \$ | \$ 2,020 | \$ 4 |
| Available for Sale | | | | | | |
| U.S. government agencies and corporations | \$ 1,015,186 | \$ 4,709 | \$ 281,852 | \$ 5,947 | \$ 1,297,038 | \$ 10,656 |
| States and political subdivisions | 352,639 | 25,101 | 3,591 | 248 | 356,230 | 25,349 |
| Total | \$ 1,367,825 | \$ 29,810 | \$ 285,443 | \$ 6,195 | \$ 1,653,268 | \$ 36,005 |

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

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 cost.

Table of Contents

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, 2008, 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, 2008 | Percentage of Total | December 31, 2007 | Percentage of Total | September 30, 2007 | Percentage of Total |
|--|-----------------------|------------------------|----------------------|------------------------|-----------------------|------------------------|
| Commercial and industrial: | | | | | | |
| Commercial | \$ 3,815,826 | 44.4% | \$ 3,472,759 | 44.7% | \$ 3,234,509 | 43.4% |
| Leases | 198,774 | 2.3 | 184,140 | 2.4 | 182,553 | 2.4 |
| Asset-based | 103,400 | 1.2 | 32,963 | 0.4 | 35,879 | 0.5 |
| Total commercial and industrial | 4,118,000 | 47.9 | 3,689,862 | 47.5 | 3,452,941 | 46.3 |
| Real estate: | | | | | | |
| Construction: | | | | | | |
| Commercial | 677,035 | 7.9 | 560,176 | 7.2 | 580,865 | 7.8 |
| Consumer | 58,888 | 0.7 | 61,595 | 0.8 | 73,209 | 1.0 |
| Land: | | | | | | |
| Commercial | 370,935 | 4.3 | 397,319 | 5.1 | 390,796 | 5.2 |
| Consumer | 1,892 | | 2,996 | | 3,631 | 0.1 |
| Commercial mortgages | 2,200,798 | 25.6 | 1,982,786 | 25.5 | 1,892,456 | 25.3 |
| 1-4 family residential mortgages | 83,099 | 1.0 | 98,077 | 1.3 | 104,073 | 1.4 |
| Home equity and other consumer | 688,153 | 8.0 | 587,721 | 7.6 | 559,860 | 7.5 |
| Total real estate | 4,080,800 | 47.5 | 3,690,670 | 47.5 | 3,604,890 | 48.3 |
| Consumer: | | | | | | |
| Indirect | 1,382 | | 2,031 | | 2,324 | |
| Student loans held for sale | 32,097 | 0.4 | 62,861 | 0.8 | 71,100 | 1.0 |
| Other | 343,723 | 4.0 | 323,320 | 4.2 | 317,045 | 4.2 |
| Other | 47,238 | 0.5 | 29,891 | 0.4 | 41,863 | 0.6 |
| Unearned discounts | (27,254) | (0.3) | (29,273) | (0.4) | (29,408) | (0.4) |
| Total loans | \$ 8,595,986 | 100.0% | \$ 7,769,362 | 100.0% | \$ 7,460,755 | 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, 2008, 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. During the second quarter of 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. The Corporation expects to complete the sale of the remainder of the student loan portfolio in 2009.

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, 2008 or December 31, 2007.

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

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 \$45.5 million at September 30, 2008 and \$24.4 million at December 31, 2007. Accruing loans past due more than 90 days totaled \$7.8 million at September 30, 2008 and \$14.3 million at December 31, 2007.

Table of Contents

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, 2008 | December 31, 2007 | September 30, 2007 |
|---|-----------------------|----------------------|-----------------------|
| Balance of impaired loans with no allocated allowance | \$ 22,235 | \$ 14,986 | \$ 7,690 |
| Balance of impaired loans with an allocated allowance | 17,260 | 2,166 | 6,071 |
| Total recorded investment in impaired loans | \$ 39,495 | \$ 17,152 | \$ 13,761 |
| Amount of the allowance allocated to impaired loans | \$ 6,181 | \$ 1,556 | \$ 2,366 |

The impaired loans included in the table above were primarily comprised of collateral dependent commercial loans. The average recorded investment in impaired loans was \$36.7 million and \$28.2 million during the three and nine months ended September 30, 2008 and \$25.9 million and \$34.0 million for the three and nine months ended September 30, 2007. 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, 2008 | | Nine Months Ended September 30, 2008 | |
|--|---|---------------|--|---------------|
| | 2008 | 2007 | 2008 | 2007 |
| Balance at the beginning of the period | \$ 94,520 | \$ 96,071 | \$ 92,339 | \$ 96,085 |
| Provision for possible loan losses | 18,940 | 5,784 | 29,273 | 11,084 |
| Net charge-offs: | | | | |
| Losses charged to the allowance | (8,093) | (11,739) | (21,298) | (19,877) |
| Recoveries of loans previously charged off | 1,742 | 2,147 | 6,795 | 4,971 |
| Net charge-offs | (6,351) | (9,592) | (14,503) | (14,906) |
| Balance at the end of the period | \$ 107,109 | \$ 92,263 | \$ 107,109 | \$ 92,263 |

Note 6 Goodwill and Other Intangible Assets

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

Goodwill. Goodwill totaled \$526.9 million at September 30, 2008 and \$526.9 million at December 31, 2007. The increase in goodwill related to the acquisition of Seeberger was offset by a decrease in goodwill related to the final purchase accounting adjustments for the acquisition of Prime Benefits in December 2007 (see Note 2 -Mergers and Acquisitions).

Other Intangible Assets. Other intangible assets totaled \$26.6 million at September 30, 2008 including \$22.9 million related to core deposits, \$3.1 million related to customer relationships and \$661 thousand related to non-compete agreements. Other intangible assets totaled \$31.5 million at December 31, 2007 including \$27.8 million related to core deposits, \$2.5 million related to customer relationships and \$1.2 million related to non-compete agreements. The changes in intangibles related to customer relationships and non-compete agreements were partly due to the acquisition of Seeberger and purchase accounting adjustments related to the acquisition of Prime Benefits.

Table of Contents

Amortization expense related to intangible assets totaled \$2.0 million and \$6.0 million during the three and nine months ended September 30, 2008 and totaled \$2.2 million and \$6.7 million during the three and nine months ended September 30, 2007. The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2008 is as follows:

| | |
|-------------------|------------------|
| Remainder of 2008 | \$ 1,929 |
| 2009 | 6,396 |
| 2010 | 4,865 |
| 2011 | 4,054 |
| 2012 | 3,297 |
| Thereafter | 6,038 |
| | \$ 26,579 |

Note 7 Deposits

Deposits were as follows:

| | September 30, 2008 | Percentage of Total | December 31, 2007 | Percentage of Total | September 30, 2007 | Percentage of Total |
|--|-----------------------|------------------------|----------------------|------------------------|-----------------------|------------------------|
| Non-interest-bearing demand deposits: | | | | | | |
| Commercial and individual | \$ 3,303,191 | 31.1% | \$ 3,171,510 | 30.1% | \$ 3,319,808 | 32.9% |
| Correspondent banks | 435,880 | 4.1 | 350,123 | 3.4 | 207,109 | 2.1 |
| Public funds | 78,243 | 0.8 | 76,270 | 0.7 | 75,863 | 0.7 |
| Total non-interest-bearing demand deposits | 3,817,314 | 36.0 | 3,597,903 | 34.2 | 3,602,780 | 35.7 |
| Interest-bearing deposits: | | | | | | |
| Private accounts: | | | | | | |
| Savings and interest checking | 1,715,707 | 16.1 | 1,722,305 | 16.4 | 1,319,010 | 13.1 |
| Money market accounts | 3,475,607 | 32.7 | 3,404,472 | 32.3 | 3,413,701 | 33.8 |
| Time accounts under \$100,000 | 591,535 | 5.6 | 618,719 | 5.9 | 622,758 | 6.2 |
| Time accounts of \$100,000 or more | 697,871 | 6.6 | 801,269 | 7.6 | 803,752 | 7.9 |
| Public funds | 320,186 | 3.0 | 385,005 | 3.6 | 333,831 | 3.3 |
| Total interest-bearing deposits | 6,800,906 | 64.0 | 6,931,770 | 65.8 | 6,493,052 | 64.3 |
| Total deposits | \$ 10,618,220 | 100.0% | \$ 10,529,673 | 100.0% | \$ 10,095,832 | 100.0% |

At September 30, 2008 and December 31, 2007, interest-bearing public funds deposits included \$141.3 million and \$170.5 million in savings and interest checking accounts, \$85.5 million and \$107.6 million in money market accounts, \$3.4 million and \$4.8 million in time accounts under \$100 thousand, and \$90.0 million and \$102.1 million in time accounts of \$100 thousand or more.

Deposits from foreign sources, primarily Mexico, totaled \$664.7 million at September 30, 2008 and \$699.5 million at December 31, 2007.

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.

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

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 \$4.9 billion and \$4.8 billion at September 30, 2008 and December 31, 2007.

Table of Contents

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 were 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 \$309.4 million at September 30, 2008 and \$235.9 million at December 31, 2007. The Corporation had an accrued liability totaling \$1.7 million at September 30, 2008 and \$1.4 million at December 31, 2007 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 \$13.8 million for the three and nine months ended September 30, 2008 and \$4.5 million and \$13.5 million for the three and nine months ended September 30, 2007. There has been no significant change in the future minimum lease payments payable by the Corporation since December 31, 2007. See the 2007 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 January 7, 2008, the Corporation redeemed \$3.1 million of floating rate (three-month LIBOR plus a margin of 3.30%) junior subordinated deferrable interest debentures, due January 7, 2033, held of record by Alamo Trust. Concurrently, the \$3.0 million of floating rate (three-month LIBOR plus a margin of 3.30%) trust preferred securities issued by Alamo Trust were also redeemed.

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 notes mature on February 15, 2017. 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 \$132 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 \$60 million of the Corporation's aggregate \$150 million of 6.875% subordinated notes payable (of which the permissible portion decreases 20% per year during the final five years of the term of the notes) and a permissible portion of the allowance for possible loan losses. The \$100 million of 5.75% fixed-to-floating rate subordinated notes issued in 2007 are not

included in Tier 1 capital but are included in total capital of Cullen/Frost.

Table of Contents

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, 2008 | | | | | | |
| Total Capital to Risk-Weighted Assets | | | | | | |
| Cullen/Frost | \$ 1,446,700 | 12.67% | \$ 913,339 | 8.00% | N/A | N/A |
| Frost Bank | 1,352,814 | 11.86 | 912,807 | 8.00 | \$ 1,141,009 | 10.00% |
| Tier 1 Capital to Risk-Weighted Assets | | | | | | |
| Cullen/Frost | 1,179,591 | 10.33 | 456,670 | 4.00 | N/A | N/A |
| Frost Bank | 1,185,705 | 10.39 | 456,404 | 4.00 | 684,606 | 6.00 |
| Leverage Ratio | | | | | | |
| Cullen/Frost | 1,179,591 | 9.04 | 521,992 | 4.00 | N/A | N/A |
| Frost Bank | 1,185,705 | 9.09 | 521,683 | 4.00 | 652,104 | 5.00 |
| December 31, 2007 | | | | | | |
| Total Capital to Risk-Weighted Assets | | | | | | |
| Cullen/Frost | \$ 1,353,125 | 12.59% | \$ 859,730 | 8.00% | N/A | N/A |
| Frost Bank | 1,288,306 | 12.05 | 855,265 | 8.00 | \$ 1,069,081 | 10.00% |
| Tier 1 Capital to Risk-Weighted Assets | | | | | | |
| Cullen/Frost | 1,070,786 | 9.96 | 429,865 | 4.00 | N/A | N/A |
| Frost Bank | 1,105,967 | 10.35 | 427,632 | 4.00 | 641,449 | 6.00 |
| Leverage Ratio | | | | | | |
| Cullen/Frost | 1,070,786 | 8.37 | 511,636 | 4.00 | N/A | N/A |
| Frost Bank | 1,105,967 | 8.65 | 511,164 | 4.00 | 638,955 | 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 capital, 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, 2008, 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 and Summit Bancshares Statutory Trust I, have not been included in the Corporation's consolidated financial statements. However, the \$132 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.

Table of Contents**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, 2008 and December 31, 2007 are presented in the following table. The Corporation obtains dealer quotations to value its prime-rate loan swaps designated as hedges of cash flows. The Corporation utilizes internal valuation models with observable market data inputs to estimate fair values of customer interest rate swaps, caps and floors.

| | September 30, 2008 | | December 31, 2007 | |
|---|--------------------|-------------------------|--------------------|-------------------------|
| | Notional Amount | Estimated Fair Value | Notional Amount | Estimated Fair Value |
| Interest rate derivatives designated as hedges of fair value: | | | | |
| Interest rate swaps on commercial loans/leases | \$ 166,308 | \$ (6,174) | \$ 180,908 | \$ (5,600) |
| Interest rate derivatives designated as hedges of cash flows: | | | | |
| Interest rate swaps on variable-rate loans | 1,200,000 | 68,112 | 1,200,000 | 33,857 |
| Non-hedging interest rate derivatives: | | | | |
| Interest rate swaps on commercial loans/leases | 485,108 | 17,222 | 328,226 | 12,928 |
| Interest rate swaps on commercial loans/leases | 485,108 | (17,222) | 328,226 | (12,928) |
| Interest rate caps on commercial loans/leases | 4,591 | 20 | | |
| Interest rate caps on commercial loans/leases | 4,591 | (20) | | |
| Interest rate floors on commercial loans/leases | 4,591 | 31 | | |
| Interest rate floors on commercial loans/leases | 4,591 | (31) | | |

The weighted-average rates paid and received for interest rate swaps and the weighted-average strike rates for interest rate caps and floors outstanding at September 30, 2008 were as follows:

| | Interest Rate Paid | Weighted-Average Interest Rate Received | Strike Rate |
|--|--------------------------|--|----------------|
| Interest rate swaps: | | | |
| Fair value hedge commercial loan/lease interest rate swaps | 4.82% | 2.90% | |
| Cash flow hedge interest rate swaps on variable-rate loans | 5.00 | 7.56 | |
| Non-hedging interest rate swaps | 5.16 | 5.16 | |
| Interest rate caps and floors: | | | |
| Interest rate caps on commercial loans/leases | | | 3.50% |
| Interest rate floors on commercial loans/leases | | | 3.29 |

Interest rate contracts involve the risk of dealing with both bank customers and institutional derivative counterparties and their ability to meet contractual terms. Institutional 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, credit exposure may be reduced by the amount of collateral pledged by the counterparty. The Corporation's credit exposure relating to interest rate swaps with bank customers was approximately \$16.3 million at September 30, 2008. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. The Corporation's credit exposure, net of collateral pledged, relating to interest rate swaps with upstream financial institution counterparties was approximately \$2.9 million at September 30, 2008. Collateral levels for upstream financial institution counterparties are monitored and adjusted on a regular basis for changes in interest rate swap values.

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

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 gain related to derivatives included in accumulated other comprehensive income totaled \$44.0 million at September 30, 2008.

Table of Contents

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 Corporation obtains dealer quotations to value its commodity derivative positions.

| | | September 30, 2008 | | December 31, 2007 | |
|--------------------|-------------------|--------------------|-------------------------|--------------------|-------------------------|
| | Notional Units | Notional Amount | Estimated Fair Value | Notional Amount | Estimated Fair Value |
| Commodity swaps: | | | | | |
| Oil | Barrels | 210 | \$ 7,091 | 355 | \$ 7,997 |
| Oil | Barrels | 210 | (7,039) | 355 | (7,909) |
| Natural gas | MMBTUs | 1,005 | 1,082 | 1,510 | 820 |
| Natural gas | MMBTUs | 1,005 | (1,050) | 1,510 | (786) |
| Commodity options: | | | | | |
| Oil | Barrels | 856 | 8,767 | 383 | 3,335 |
| Oil | Barrels | 856 | (8,740) | 383 | (3,334) |

The Corporation's credit exposure on commodity swaps/options is limited to the net favorable value of all swaps/options by each counterparty. In such cases, credit exposure may be reduced by the amount of collateral pledged by the counterparty. The Corporation's credit exposure relating to commodity swaps/options with bank customers was approximately \$9.7 million at September 30, 2008. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. The Corporation's credit exposure in excess of collateral pledged relating to commodity swaps/options with upstream financial institution counterparties was not significant at September 30, 2008. Collateral levels for upstream financial institution counterparties are monitored and adjusted on a regular basis for changes in commodity swap/option values.

Foreign Currency Derivatives. The Corporation enters into foreign currency forward 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, 2008 and December 31, 2007.

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, | |
|--|-------------------------------------|------------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Weighted-average shares outstanding for basic earnings per share | 58,932,372 | 58,438,992 | 58,735,792 | 59,141,846 |
| Dilutive effect of stock options and non-vested stock awards | 433,084 | 730,618 | 483,114 | 820,485 |
| Weighted-average shares outstanding for diluted earnings per share | 59,365,456 | 59,169,610 | 59,218,906 | 59,962,331 |

Table of Contents**Note 13 Stock-Based Compensation**

A combined summary of activity in the Corporation's active stock plans is presented in the following table.

| | Shares Available for Grant | Non-Vested Stock Awards Outstanding Number of Shares | Weighted- Average Grant-Date Fair Value | Stock Options Outstanding Number of Shares | Weighted- Average Exercise Price |
|---------------------------------------|----------------------------------|---|--|---|---|
| Balance, January 1, 2008 | 1,896,150 | 233,100 | \$ 50.68 | 4,526,276 | \$ 45.44 |
| Granted | (2,000) | | | 2,000 | 53.55 |
| Director deferred stock units awarded | (5,450) | | | | |
| Stock options exercised | | | | (1,041,600) | 33.09 |
| Stock awards vested | | (1,500) | 42.53 | | |
| Forfeited | 32,150 | | | (32,150) | 51.99 |
| Canceled | (1,500) | | | | |
| Balance, September 30, 2008 | 1,919,350 | 231,600 | 50.73 | 3,454,526 | 49.10 |

During the second quarter of 2008, the Corporation awarded non-employee directors a total of 5,450 deferred stock units. Upon retirement from the Corporation's board of directors, non-employee directors will receive one share of the Corporation's common stock for each deferred stock unit held. The deferred stock units were fully vested upon being awarded and will receive equivalent dividend payments as such dividends are declared on the Corporation's common stock. The Corporation recognized stock-compensation expense totaling \$300 thousand related to the award of deferred stock units during the second quarter of 2008. The expense was based upon the market price of the Corporation's stock on the date of the awards.

During the nine months ended September 30, 2008 and 2007, proceeds from stock option exercises totaled \$34.5 million and \$18.5 million. During the nine months ended September 30, 2008, all of the shares issued in connection with stock option exercises were issued from available treasury stock.

Stock-based compensation expense totaled \$2.4 million and \$7.4 million during the three and nine months ended September 30, 2008 and \$2.4 million and \$7.5 million during the three and nine months ended September 30, 2007. 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 \$13.6 million at September 30, 2008, while unrecognized stock-based compensation expense related to non-vested stock awards was \$4.5 million at September 30, 2008.

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, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Expected return on plan assets, net of expenses | \$ (2,310) | \$ (2,047) | \$ (6,930) | \$ (6,141) |
| Interest cost on projected benefit obligation | 1,935 | 1,869 | 5,806 | 5,607 |
| Net amortization and deferral | 307 | 663 | 922 | 1,991 |
| Net periodic benefit cost | \$ (68) | \$ 485 | \$ (202) | \$ 1,457 |

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

The Corporation's non-qualified defined benefit pension plan is not funded. Contributions to the qualified defined benefit pension plan totaled \$5.2 million through September 30, 2008. The Corporation does not expect to make any additional contributions during the remainder of 2008.

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.

Table of Contents**Note 15 Income Taxes**

Income tax expense was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|---|------------------|--|------------------|
| | 2008 | 2007 | 2008 | 2007 |
| Current income tax expense | \$ 27,481 | \$ 25,314 | \$ 72,760 | \$ 72,843 |
| Deferred income tax expense (benefit) | (6,307) | 252 | (5,359) | 231 |
| Income tax expense as reported | \$ 21,174 | \$ 25,566 | \$ 67,401 | \$ 73,074 |
| Effective tax rate | 30.2% | 31.2% | 30.4% | 31.7% |

Net deferred tax assets totaled \$19.9 million at September 30, 2008 and \$27.9 million at December 31, 2007. No valuation allowance was recorded against deferred tax assets, as the amounts are recoverable through taxes paid in prior years.

The Corporation adopted the provisions of Financial Accounting Standards Board (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 with the U.S. Internal Revenue Service (IRS). The Company is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2005. During the third quarter of 2007, the 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 is managed under a matrix organizational structure whereby significant lines of business, including Banking and the Financial Management Group (FMG), overlap a regional reporting structure. The regions are primarily based upon geographic location and include Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley, San Antonio and Statewide. The Corporation is primarily managed based on the line of business structure. In that regard, all regions have the same lines of business, which have the same product and service offerings, have similar types and classes of customers and utilize similar service delivery methods. Pricing guidelines for products and services are the same across all regions. The regional reporting structure is primarily a means to scale the lines of business to provide a local, community focus for customer relations and business development.

The Corporation has two primary operating segments, Banking and FMG, that are delineated by the products and services that each segment offers. The Banking operating segment 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. Frost Insurance Agency provides insurance brokerage services to individuals and businesses covering corporate and personal property and casualty products, as well as group health and life insurance products. Frost Securities, Inc. provides advisory and private equity services to middle market companies. The FMG operating segment includes fee-based services within private trust, retirement services, and financial management services, including personal wealth management and brokerage services. The third operating segment, Non-Banks, is for the most part the parent holding company, as well as certain other insignificant non-bank subsidiaries of the parent that, for the most part, have little or no activity. The parent company's principal activities include the direct and indirect ownership of the Corporation's banking and non-banking subsidiaries and the issuance of debt. Its

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

principal source of revenue is dividends from its subsidiaries.

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 and general overhead-type expenses such as executive administration, accounting and internal audit are allocated to operating segments based on estimated uses of those services, (ii) income tax expense for the individual segments is calculated essentially at the statutory rate, and (iii) the parent company records the tax expense or benefit necessary to reconcile to the consolidated total.

Table of Contents

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, 2008 | \$ 183,216 | \$ 30,948 | \$ (2,113) | \$ 212,051 |
| September 30, 2007 | 176,534 | 28,776 | (3,930) | 201,380 |
| Nine months ended: | | | | |
| September 30, 2008 | \$ 532,006 | \$ 89,998 | \$ (7,936) | \$ 614,068 |
| September 30, 2007 | 518,047 | 83,581 | (11,803) | 589,825 |
| Net income (loss): | | | | |
| Three months ended: | | | | |
| September 30, 2008 | \$ 42,924 | \$ 7,417 | \$ (1,376) | \$ 48,965 |
| September 30, 2007 | 51,904 | 7,435 | (2,876) | 56,463 |
| Nine months ended: | | | | |
| September 30, 2008 | \$ 140,062 | \$ 20,748 | \$ (6,518) | \$ 154,292 |
| September 30, 2007 | 150,603 | 19,541 | (12,773) | 157,371 |

Note 17 Fair Value Measurements

Effective January 1, 2008, the Corporation adopted the provisions of SFAS No. 157, Fair Value Measurements, for financial assets and financial liabilities. In accordance with Financial Accounting Standards Board Staff Position (FSP) No. SFAS 157-2, Effective Date of FASB Statement No. 157, the Corporation will delay application of SFAS 157 for non-financial assets and non-financial liabilities, until January 1, 2009. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The application of SFAS 157 in situations where the market for a financial asset is not active was clarified by the issuance of FSP No. SFAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, in October 2008. FSP No. SFAS 157-3 became effective for the Corporation's interim financial statements as of September 30, 2008 and did not significantly impact the methods by which the Corporation determines the fair values of its financial assets.

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

SFAS 157 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, SFAS 157 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

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

Table of Contents

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

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

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Corporation's financial assets and financial liabilities carried at fair value effective January 1, 2008.

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

Securities Available for Sale. U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Corporation obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Trading Securities. U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as trading are reported at fair value utilizing Level 2 inputs in the same manner as described above for securities available for sale.

Derivatives. Derivatives are reported at fair value utilizing Level 2 inputs. The Corporation obtains dealer quotations to value its prime-rate loan swaps, commodity swaps/options and foreign currency contracts. The Corporation utilizes internal valuation models with observable market data inputs to estimate fair values of customer interest rate swaps, caps and floors. The Corporation also obtains dealer quotations for these derivatives for comparative purposes to assess the reasonableness of the model valuations.

Impaired Loans. Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2008, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|-------------------------------|-------------------|-------------------|-------------------|---------------------|
| Securities available for sale | \$ 24,986 | \$ 3,145,669 | \$ | \$ 3,170,655 |
| Trading account securities | 14,403 | 10,968 | | 25,371 |
| Derivative assets | | 102,325 | | 102,325 |
| Derivative liabilities | | 40,276 | | 40,276 |

Table of Contents

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). During the nine months ended September 30, 2008, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for possible loan losses based upon the fair value of the underlying collateral. Impaired loans with a carrying value of \$3.5 million were reduced by specific valuation allowance allocations totaling \$774 thousand to a total reported fair value of \$2.8 million based on collateral valuations utilizing Level 2 valuation inputs. Impaired loans with a carrying value of \$7.3 million were reduced by specific valuation allowance allocations totaling \$4.0 million to a total reported fair value of \$3.3 million based on collateral valuations utilizing Level 3 valuation inputs.

Certain non-financial assets and non-financial liabilities measured at fair value on a recurring basis include reporting units measured at fair value in the first step of a goodwill impairment test. Certain non-financial assets measured at fair value on a non-recurring basis include non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, as well as intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. As stated above, SFAS 157 will be applicable to these fair value measurements beginning January 1, 2009.

Effective January 1, 2008, the Corporation adopted the provisions of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115. SFAS 159 permits the Corporation to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value measurement 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, thus the Corporation may record identical financial assets and liabilities at fair value or by another measurement basis permitted under generally accepted accounting principles, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. Adoption of SFAS 159 on January 1, 2008 did not have a significant impact on the Corporation's financial statements.

Note 18 New Accounting Standards

Statements of Financial Accounting Standards

SFAS No. 141, Business Combinations (Revised 2007). SFAS 141R replaces SFAS 141, *Business Combinations*, and applies to all transactions and other events in which one entity obtains control over one or more other businesses. SFAS 141R requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, would have to be met by the target in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, *Accounting for Contingencies*. SFAS 141R is expected to have a significant impact on the Corporation's accounting for business combinations closing on or after January 1, 2009.

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

Table of Contents

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 (see Note 17 Fair Value Measurements).

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 (see Note 17 Fair Value Measurements).

SFAS No. 160, Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB Statement No. 51. SFAS 160 amends Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 clarifies that a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, SFAS 160 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. SFAS 160 is effective for the Corporation on January 1, 2009 and is not expected to have a significant impact on the Corporation's financial statements.

SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133. SFAS 161 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities, to amend and expand the disclosure requirements of SFAS 133 to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under SFAS 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. To meet those objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for the Corporation on January 1, 2009 and is not expected to have a significant impact on the Corporation's financial statements.

SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The hierarchical guidance provided by SFAS 162 did not have a significant impact on the Corporation's financial statements.

Financial Accounting Standards Board Staff Positions

FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. FSP EITF 03-6-1 provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. FSP EITF 03-6-1 will be effective on January 1, 2009. All previously reported earnings per share data will be retrospectively adjusted to conform with the provisions of FSP EITF 03-6-1. FSP EITF 03-6-1 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.

Emerging Issues Task Force Issues

Emerging Issues Task Force (EITF) Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements. EITF 06-4 requires the recognition of a liability and related compensation expense for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to post-retirement periods. Under EITF 06-4, life insurance policies purchased for the purpose of providing such benefits do not effectively settle an entity's obligation to the employee. Accordingly, the entity must recognize a liability and related compensation expense during the employee's active service period based on the future cost of insurance to be incurred during the employee's retirement. If the entity has agreed to provide the employee with a death benefit, then the liability for the

Table of Contents

future death benefit should be recognized by following the guidance in SFAS 106, *Employer's Accounting for Postretirement Benefits Other Than Pensions*. The Corporation adopted EITF 06-4 on January 1, 2008 as a change in accounting principle through a cumulative-effect adjustment to retained earnings totaling \$240 thousand.

SEC Staff Accounting Bulletins

SAB No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings. SAB No. 109 supersedes SAB 105, *Application of Accounting Principles to Loan Commitments*, and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The guidance in SAB 109 became effective on January 1, 2008 and did not have a material impact on the Corporation's financial statements.

Note 19 Subsequent Event

On October 16, 2008, the Corporation entered into an interest rate swap contract with a total notional amount of \$120.0 million. The interest rate swap contract was designated as a hedging instrument in a cash flow hedge with the objective of protecting the quarterly interest payments on the Corporation's \$120.0 million of junior subordinated deferrable interest debentures issued to Cullen/Frost Capital Trust II throughout the five-year period beginning on December 1, 2008 and ending on December 1, 2013 from the risk of variability of those payments resulting from changes in the three-month LIBOR interest rate. The terms of the interest rate swap contract provide that the Corporation will pay a fixed interest rate of 5.47% over the term of the contract and receive a variable interest rate of three-month LIBOR plus a margin of 1.55% on a total notional amount of \$120.0 million, with quarterly settlements. The interest rate swap was entered into on October 16, 2008 at current market rates. Accordingly, no premium was paid or received in connection with the swap.

Table of Contents

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, 2007, included in the 2007 Form 10-K. Operating results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results for the year ending December 31, 2008 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 words 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.

Volatility and disruption in national and international financial markets.

Government intervention in the U.S. financial system.

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.

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

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.

Table of Contents

Recent Market Developments

The global and U.S. economies are experiencing significantly reduced business activity as a result of, among other factors, disruptions in the financial system during the past year. Dramatic declines in the housing market during the past year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail.

Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced, and in some cases, ceased to provide funding to borrowers, including other financial institutions. The availability of credit, confidence in the financial sector, and level of volatility in the financial markets have been significantly adversely affected as a result. In recent weeks, volatility and disruption in the capital and credit markets has reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit capacity for certain issuers without regard to those issuers' underlying financial strength.

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the EESA) was signed into law. Pursuant to the EESA, the U.S. Treasury will have the authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets.

On October 14, 2008, Secretary Paulson, after consulting with the Federal Reserve and the FDIC, announced that the Department of the Treasury will purchase equity stakes in a wide variety of banks and thrifts. Under this program, known as the Troubled Asset Relief Program Capital Purchase Program (the TARP Capital Purchase Program), from the \$700 billion authorized by the EESA, the Treasury will make \$250 billion of capital available to U.S. financial institutions in the form of preferred stock. In conjunction with the purchase of preferred stock, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15% of the preferred investment. Participating financial institutions will be required to adopt the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the TARP Capital Purchase Program. Secretary Paulson also announced that nine large financial institutions have already agreed to participate in the TARP Capital Purchase Program.

Also on October 14, 2008, after receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, Secretary Paulson signed the systemic risk exception to the FDIC Act, enabling the FDIC to temporarily provide a 100% guarantee of the senior debt of all FDIC-insured institutions and their holding companies, as well as deposits in non-interest bearing transaction deposit accounts under a Temporary Liquidity Guarantee Program. Coverage under the Temporary Liquidity Guarantee Program is available for 30 days without charge and thereafter at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for non-interest bearing transaction deposits. The Corporation is assessing its participation in both the TARP Capital Purchase Program and the Temporary Liquidity Guarantee Program but has not yet made a definitive decision as to whether it will participate.

It is not clear at this time what impact the EESA, the TARP Capital Purchase Program, the Temporary Liquidity Guarantee Program, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the financial markets and the other difficulties described above, including the extreme levels of volatility and limited credit availability currently being experienced, or on the U.S. banking and financial industries and the broader U.S. and global economies. Further adverse effects could have an adverse effect on the Corporation and its business.

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

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

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

Table of Contents

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 2007 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, 2007.

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 \$49.0 million, or \$0.82 diluted per share, for the three months ended September 30, 2008 compared to \$56.5 million, or \$0.95 diluted per share, for the three months ended September 30, 2007, and \$52.5 million, or \$0.89 diluted per share, for the three months ended June 30, 2008. Net income totaled \$154.3 million, or \$2.61 diluted per share, for the nine months ended September 30, 2008 compared to \$157.4 million, or \$2.62 diluted per share, for the nine months ended September 30, 2007. As further discussed in the sections captioned

Non-Interest Expense and Allowance for Possible Loan Losses, the Corporation recognized approximately \$1.0 million of expenses and a provision for possible loan losses totaling approximately \$10 million for probable loan losses related to Hurricane Ike, which impacted the Corporation's Houston and Galveston market areas during the third quarter of 2008.

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

| | Three Months Ended | | | Nine Months Ended | |
|--|-----------------------|------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2008 | June 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Taxable-equivalent net interest income | \$ 139,655 | \$ 136,223 | \$ 134,704 | \$ 410,647 | \$ 398,926 |
| Taxable-equivalent adjustment | 4,919 | 4,895 | 4,080 | 14,703 | 10,949 |
| Net interest income | 134,736 | 131,328 | 130,624 | 395,944 | 387,977 |
| Provision for possible loan losses | 18,940 | 6,328 | 5,784 | 29,273 | 11,084 |
| Net interest income after provision for possible loan losses | 115,796 | 125,000 | 124,840 | 366,671 | 376,893 |
| Non-interest income | 77,315 | 70,581 | 70,756 | 218,124 | 201,848 |
| Non-interest expense | 122,972 | 120,090 | 113,567 | 363,102 | 348,296 |
| Income before income taxes | 70,139 | 75,491 | 82,029 | 221,693 | 230,445 |
| Income taxes | 21,174 | 22,944 | 25,566 | 67,401 | 73,074 |
| Net income | \$ 48,965 | \$ 52,547 | \$ 56,463 | \$ 154,292 | \$ 157,371 |
| Earnings per common share - basic | \$ 0.83 | \$ 0.89 | \$ 0.97 | \$ 2.63 | \$ 2.66 |
| Earnings per common share - diluted | 0.82 | 0.89 | 0.95 | 2.61 | 2.62 |
| Dividends per common share | 0.42 | 0.42 | 0.40 | 1.24 | 1.14 |
| Return on average assets | 1.44% | 1.56% | 1.72% | 1.53% | 1.62% |
| Return on average equity | 12.39 | 13.44 | 16.44 | 13.23 | 15.21 |

Net income for the three and nine months ended September 30, 2008 decreased \$7.5 million, or 13.3%, and \$3.1 million, or 2.0%, compared to the same periods in 2007. The decrease during the three months ended September 30, 2008 was primarily the result of a \$13.2 million increase in the provision for possible loan losses and a \$9.4 million increase in non-interest expense partly offset by a \$6.6 million increase in non-interest income, a \$4.1 million increase in net interest income and a \$4.4 million decrease in income tax expense. The decrease during the

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

nine months ended September 30, 2008 was primarily the result of an \$18.2 million increase in the provision for possible loan losses and a \$14.8 million increase in non-interest expense partly offset by a \$16.3 million increase in non-interest income, an \$8.0 million increase in net interest income and a \$5.7 million decrease in income tax expense.

Net income for the third quarter of 2008 decreased \$3.6 million, or 6.8%, from the second quarter of 2008. The decrease was primarily the result of a \$12.6 million increase in the provision for possible loan losses and a \$2.9 million increase in non-interest expense partly offset by a \$6.7 million increase in non-interest income, a \$3.4 million increase in net interest income and a \$1.8 million decrease in income tax expense.

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

Table of Contents**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 64.5% of total revenue during the first nine months of 2008. 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 2007 at 8.25% and decreased 50 basis points in the third quarter and 50 basis in the fourth quarter to end the year at 7.25%. During the first nine months of 2008, the prime interest rate decreased 200 basis points in the first quarter and 25 basis points in the second quarter to end the period at 5.00%. The federal funds rate, which is the cost of immediately available overnight funds, has moved in a similar manner. It began 2007 at 5.25% and decreased 50 basis points in the third quarter and 50 basis points in the fourth quarter to end the year at 4.25%. During the first nine months of 2008, the federal funds rate decreased 200 basis points in the first quarter and 25 basis points in the second quarter to end the period at 2.00%.

The Corporation's balance sheet has historically been asset sensitive, meaning that earning assets generally reprice more quickly than interest-bearing liabilities. Therefore, the Corporation's net interest margin was likely to increase in sustained periods of rising interest rates and decrease in sustained periods of declining interest rates. In an effort to make the Corporation's balance sheet less sensitive to changes in interest rates, the Corporation entered into interest rate swaps during the fourth quarter of 2007 that effectively convert \$1.2 billion of loans with variable interest rates tied to the prime rate into fixed rate loans for a period of seven years (see Note 17 - Derivative Financial Instruments in the 2007 Form 10-K). As a result, the Corporation's balance sheet is more interest-rate neutral and changes in interest rates are expected to have a less significant impact on the Corporation's net interest margin. 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. As stated above, during the first nine months of 2008, the federal funds rate and the prime interest rate each decreased 225 basis points to 2.00% and 5.00%, respectively. Furthermore, on October 8, 2008, the federal funds rate and the prime interest rate each decreased 50 basis points to 1.50% and 4.50%, respectively. The Corporation currently believes that it is reasonably possible that the federal funds rate and the prime interest rate will be further reduced in the foreseeable future; however, there can be no assurance to that effect as changes in market interest rates are dependent upon a variety of factors that are beyond the Corporation's control. Further analysis of the components of the Corporation's net interest margin is presented below.

The following table presents the changes in taxable-equivalent net interest income and identifies the changes due to differences in the average volume of earning assets and interest-bearing liabilities and the changes due to changes in the average interest rate on those assets and liabilities. The changes in net interest income due to changes in both average volume and average interest rate have been allocated to 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 2008 vs. Third Quarter 2007 | Third Quarter 2008 vs. Second Quarter 2008 | First Nine Months 2008 vs. First Nine Months 2007 |
|---|--|---|--|
| Due to changes in average volumes | \$ 3,582 | \$ 437 | \$ 10,222 |
| Due to changes in average interest rates | 1,369 | 1,477 | |
| Due to difference in the number of days in each of the comparable periods | | 1,518 | 1,499 |
| Total change | \$ 4,951 | \$ 3,432 | \$ 11,721 |

Taxable-equivalent net interest income for the three months ended September 30, 2008 increased \$5.0 million, or 3.7%, compared to the same period in 2007. The increase primarily resulted from an increase in the average volume of earning assets and an increase in the net interest margin. The average volume of interest-earning assets for the third quarter of 2008 increased \$371.5 million, or 3.3%, compared to the same period in 2007. Over the same time frame, the net interest margin increased 5 basis points from 4.69% in 2007 to 4.74% in 2008.

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

Taxable-equivalent net interest income for the nine months ended September 30, 2008 increased \$11.7 million, or 2.9%, compared to the same period in 2007. The increase primarily resulted from an increase in the average volume of interest-earning assets. The average volume of interest-earning assets for the first nine months of 2008 increased \$365.6 million, or 3.2%, compared to the same period in 2007. The increase in taxable-equivalent net interest income was also partly due to an increase in the number of days in the first nine months of 2008, due to the leap year. Taxable-equivalent net interest income for the first nine months of 2008 included 274 days compared to 273 days for the first nine months of 2007. The additional day

Table of Contents

added approximately \$1.5 million to taxable-equivalent net interest income during the first nine months of 2008. Excluding the impact of the additional day results in an effective increase in taxable-equivalent net interest income of approximately \$10.2 million during the first nine months of 2008 compared to the same period in 2007. This effective increase was the result of the aforementioned increase in the average volume of interest-earning assets.

The Corporation's net interest margin was 4.69% for both the nine months ended September 30, 2008 and 2007 despite lower average market interest rates during 2008. The effect of the lower average market interest rates was substantially mitigated by a disproportionately larger decrease in the average cost of funds, which decreased 141 basis points from 3.24% in 2007 to 1.83% in 2008, compared to the decrease in the average yield on interest-earning assets, which decreased 97 basis points from 6.95% in 2007 to 5.98% in 2008. The decreases in the average cost of funds and the average yield on interest-earning assets were primarily due to a decrease in average market interest rates. The effect of lower average market interest rates on the average yield on interest-earning assets was partly limited by the aforementioned interest rate swaps on variable-rate loans. In addition to lower average market interest rates, the cost of funds was further impacted by an increase in the relative proportion of lower-cost savings and interest checking deposits in 2008 relative to 2007. The negative impact of lower average market interest rates on the average yield on interest-earning assets was partly limited as the Corporation had a larger proportion of average interest-earning assets invested in higher-yielding loans, which increased from 65.7% of total average interest-earning assets during the first nine months of 2007 to 70.1% of total average interest-earning assets during the first nine months of 2008, and a lower proportion of average interest-earning assets invested in lower-yielding federal funds sold and resell agreements during 2008 relative to 2007.

Taxable-equivalent net interest income for the third quarter of 2008 increased \$3.4 million, or 2.5%, from the second quarter of 2008. The increase primarily resulted from an increase in the net interest margin combined with an increase in the number of days in the third quarter. The net interest margin increased 6 basis points from 4.68% in the second quarter of 2008 to 4.74% in the third quarter of 2008, in part due to a decrease in the cost of funds. The cost of funds decreased 12 basis points from 1.68% in the second quarter of 2008 to 1.56% in the third quarter of 2008. Taxable-equivalent net interest income for the third quarter of 2008 included 92 days of interest accrual compared to 91 days for the second quarter of 2008. The additional day added approximately \$1.5 million to taxable-equivalent net interest income during the third quarter of 2008. Excluding the impact of the additional day during the third quarter of 2008 results in an effective increase in taxable-equivalent net interest income of approximately \$1.9 million compared to the second quarter of 2008. This effective increase was primarily the result of the aforementioned increase in the net interest margin.

The average volume of loans, the Corporation's primary category of earning assets, increased \$749.0 million during the first nine months of 2008 compared to the same period in 2007. The average yield on loans was 6.28% during the first nine months of 2008 compared to 7.86% during the same period in 2007. As stated above, the Corporation had a larger proportion of average earning assets invested in loans during the first nine months of 2008 compared to the first nine months of 2007. 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 \$106.7 million during the first nine months of 2008 compared to the same period in 2007. The average yield on securities was 5.39% during the first nine months of 2008 compared to 5.22% during the first nine months of 2007. Average federal funds sold and resell agreements during the first nine months of 2008 decreased \$489.2 million compared to the same period in 2007. The average yield on federal funds sold and resell agreements was 2.77% during the first nine months of 2008 compared to 5.27% during the first nine months of 2007.

Average deposits increased \$203.4 million during the first nine months of 2008 compared to the same period in 2007. Average interest-bearing deposits for the first nine months of 2008 increased \$190.0 million compared to the same period in 2007. The ratio of average interest-bearing deposits to total average deposits was 65.9% for the first nine months of 2008 compared to 65.3% during the first nine months of 2007. The average cost of interest-bearing deposits and total deposits was 1.63% and 1.07% during the first nine months of 2008 compared to 2.95% and 1.93% during the first nine months of 2007. The decrease in the average cost of interest-bearing deposits was primarily the result of decreases in interest rates offered on deposit products due to decreases in average market interest rates.

The Corporation's net interest spread, which represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities, was 4.15% during the first nine months of 2008 compared to 3.71% during the first nine months of 2007. 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.

Table of Contents**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 \$18.9 million and \$29.3 million for the three and nine months ended September 30, 2008 compared to \$5.8 million and \$11.1 million for the three and nine months ended September 30, 2007. As stated above, during the third quarter of 2008, the Corporation recorded a provision for possible loan losses totaling approximately \$10 million for probable loan losses related to Hurricane Ike, which impacted the Corporation's Houston and Galveston market areas. 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, 2008 | June 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Trust fees | \$ 19,749 | \$ 19,040 | \$ 17,749 | \$ 57,071 | \$ 52,350 |
| Service charges on deposit accounts | 22,642 | 21,634 | 20,696 | 63,869 | 59,674 |
| Insurance commissions and fees | 8,261 | 7,015 | 7,695 | 26,434 | 24,868 |
| Other charges, commissions and fees | 10,723 | 9,496 | 10,772 | 27,150 | 24,609 |
| Net gain (loss) on securities transactions | 78 | (56) | | (26) | |
| Other | 15,862 | 13,452 | 13,844 | 43,626 | 40,347 |
| Total | \$ 77,315 | \$ 70,581 | \$ 70,756 | \$ 218,124 | \$ 201,848 |

Total non-interest income for the three and nine months ended September 30, 2008 increased \$6.6 million, or 9.3%, and \$16.3 million, or 8.1%, compared to the same periods in 2007. Total non-interest income for the third quarter of 2008 increased \$6.7 million, or 9.5%, compared to the second quarter of 2008. 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, 2008 increased \$2.0 million, or 11.3%, and \$4.7 million, or 9.0%, compared to the same periods in 2007. Investment fees are the most significant component of trust fees, making up approximately 68% and 71% of total trust fees for the first nine months of 2008 and 2007, 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 \$2.0 million increase in trust fee income during the three months ended September 30, 2008 compared to the same period in 2007 was primarily the result of increases in oil and gas trust management fees (up \$1.3 million) and investment fees (up \$629 thousand). The \$4.7 million increase in trust fee income during the nine months ended September 30, 2008 compared to the same period in 2007 was primarily the result of increases in oil and gas trust management fees (up \$2.5 million), investment fees (up \$1.9 million) and securities lending income (up \$1.2 million). The increase in oil and gas trust management fees was partly related to new lease bonuses and increased production. The increase in securities lending income was due in part to increased transaction spreads. The increase in investment fees was primarily due to growth in average trust assets in managed accounts and the number of trust accounts. The Corporation has been successful with business development activities and customer retention despite the recent market correction in equity valuations. Equity valuations during the first nine months of 2008 have been lower on average compared to the first nine months of 2007 while bond valuations are higher as a result of lower market interest rates.

Trust fee income for the third quarter of 2008 increased \$709 thousand, or 3.7%, compared to the second quarter of 2008. Increases in oil and gas trust management fees (up \$838 thousand), investment fees (up \$386 thousand) and estate fees (up \$356 thousand) were mostly offset by a decrease in tax fees (down \$752 thousand), which are seasonally higher during the second quarter.

At September 30, 2008, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (41.4% of trust assets), equity securities (35.7% of trust assets) and cash equivalents (15.5% of trust assets). The estimated fair value of trust assets was \$23.1 billion (including managed assets of \$10.2 billion and custody assets of \$12.9 billion) at September 30, 2008, compared to

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

\$24.8 billion (including managed assets of \$10.5 billion and custody assets of \$14.3 billion) at December 31, 2007 and \$24.7 billion (including managed assets of \$10.4 billion and custody assets of \$14.3 billion) at September 30, 2007.

Table of Contents

Service Charges on Deposit Accounts. Service charges on deposit accounts for the three and nine months ended September 30, 2008 increased \$1.9 million, or 9.4%, and \$4.2 million, or 7.0%, compared to the same periods in 2007. During the three months ended September 30, 2008 increases in service charges on commercial accounts (up \$2.1 million) were partly offset by decreases in service charges on consumer accounts (down \$521 thousand). During the nine months ended September 30, 2008 increases in service charges on commercial accounts (up \$4.5 million) and in overdraft/insufficient funds charges on consumer accounts (up \$671 thousand) were partly offset by decreases in service charges on consumer accounts (down \$1.9 million). The increase in service charges on commercial accounts was primarily related to increased treasury management fees. The increased treasury management fees resulted primarily from a lower earnings credit rate. The earnings credit rate is the value given to deposits maintained by treasury management customers. Because interest rates are lower compared to the first nine months of 2007, deposit balances have become less valuable and are yielding a lower earnings credit rate. As a result, customers are paying for more of their services through fees rather than with earnings credits applied to their deposit balances. The increase in overdraft/insufficient funds charges on consumer accounts was partly the result of growth in deposit accounts and an increase in the per-occurrence fee charged during the second quarter of 2007. The decrease in service charges on consumer accounts is partly the result of a shift in the relative mix of deposit products towards lower cost/free accounts, which is partly related to a restructuring of the Corporation's deposit product offerings.

Service charges on deposit accounts for the third quarter of 2008 increased \$1.0 million, or 4.7%, compared to the second quarter of 2008. The increase was primarily due to an increase in overdraft/insufficient funds charges on consumer accounts (up \$593 thousand), which was partly the result of normal seasonal variation, and an increase in service charges on commercial accounts (up \$228 thousand), primarily from a lower earnings credit rate.

Insurance Commissions and Fees. Insurance commissions and fees for the three and nine months ended September 30, 2008 increased \$566 thousand, or 7.4%, and \$1.6 million, or 6.3%, compared to the same periods in 2007. The increases were primarily related to higher commission income (up \$471 thousand and \$1.6 million for the three and nine months ended September 30, 2008), partly related to the recent acquisitions (see Note 2 Mergers and Acquisitions).

Insurance commissions and fees include contingent commissions totaling \$140 thousand and \$3.7 million during the three and nine months ended September 30, 2008 and \$45 thousand and \$3.6 million during the three and nine months ended September 30, 2007. 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 \$3.0 million and \$3.3 million during the nine months ended September 30, 2008 and 2007. 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 \$139 thousand and \$630 thousand during the three and nine months ended September 30, 2008 and \$43 thousand and \$317 thousand during the three and nine months ended September 30, 2007.

Insurance commissions and fees for the third quarter of 2008 increased \$1.2 million, or 17.8%, compared to the second quarter of 2008. 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 months ended September 30, 2008 did not significantly fluctuate compared to the same period in 2007 as increases in mutual fund management fees (up \$815 thousand) and commission income related to the sale of money market accounts (up \$293 thousand) were mostly offset by a decrease in investment banking fees related to corporate advisory services (down \$1.0 million). The mutual fund management fees represent fee revenue related to Frost Investment Advisors, LLC, a newly formed registered investment advisor subsidiary of the Corporation. Investment banking fees related to corporate advisory services are transaction-based and can vary significantly from quarter to quarter. Investment banking fees related to corporate advisory services during the third quarter of 2007 included \$2.9 million related to a single transaction.

Other charges, commissions and fees for the nine months ended September 30, 2008 increased \$2.5 million, or 10.3%, compared to the same period in 2007. The increase was primarily related to increases in mutual fund management fees related to Frost Investment Advisors, LLC (up \$1.3 million), commission income related to the sale of money market accounts and annuities (up \$1.1 million and \$490 thousand, respectively), investment banking fees related to corporate advisory services (up \$408 thousand) and unused balance fees on loan commitments (up \$403 thousand). The increase from these items was partly offset by decreases in ATM fees (down \$563 thousand), commission income related to the sale of mutual funds (down \$520 thousand) and receivables factoring income (down \$417 thousand).

Other charges, commissions and fees for the third quarter of 2008 increased \$1.2 million, or 12.9%, compared to the second quarter of 2008. The increase was primarily due to increases in investment banking fees related to corporate advisory services (up \$1.2 million), and mutual fund management fees (up \$302 thousand) related to Frost Investment Advisors, LLC. Investment banking fees related to corporate advisory services included fees from a single transaction totaling \$2.6 million during the third quarter of 2008.

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

Net Gain/Loss on Securities Transactions. The Corporation sold available-for-sale securities with an amortized cost totaling \$888.3 million and \$14.4 million during the nine months ended September 30, 2008 and 2007. The Corporation realized a net

Table of Contents

loss of \$26 thousand on the 2008 sales. No gains or losses were realized on the 2007 sales. The Corporation sold \$599.1 million of securities during the first quarter of 2008 in connection with a restructuring of the Corporation's securities portfolio to help improve net interest income in light of actions taken by the Federal Reserve that resulted in 200 basis point declines in both the federal funds rate and the prime rate. The proceeds from the sales were reinvested in longer-term securities with higher yields. The Corporation sold \$257.2 million of securities during the second quarter of 2008, of which approximately \$190.0 million were primarily sold for liquidity management purposes to fund loan growth. During the third quarter of 2008, the Corporation sold its entire portfolio (with a book value totaling \$32.0 million) of unsecured, non-mortgage-backed securities issued by U.S. government agencies and corporations due to increasing risks associated with these investments.

Other Non-Interest Income. Other non-interest income increased \$2.0 million, or 14.6%, for the three months ended September 30, 2008 compared to the same period in 2007. Contributing to the increase were increases in mineral interest income (up \$1.3 million), sundry income from various miscellaneous items (up \$1.2 million), gains on the sale of assets (up \$1.0 million) and income from check card usage (up \$655 thousand). The increase in mineral interest income was partly related to a new lease bonus. Sundry income from various miscellaneous items generally includes various one-time, non-recurring items. During the third quarter of 2008 sundry income included \$2.2 million in income recognized from the collection of loan interest and other charges written-off in prior years. The increase in gains on the sale of assets was primarily related to a tract of land sold in connection with an eminent domain condemnation. The increases in the aforementioned items were partly offset by a decrease in earnings on cashier check balances (down \$1.0 million). The decrease in earnings on cashier check balances was primarily due to a decrease in fees received on balances maintained with the Corporation's third-party processor as such fees are tied to market interest rates which are comparatively lower in 2008 relative to 2007. During the second quarter of 2008, the Corporation began to maintain cashiers check balances in-house. Accordingly, the third-party fees on cashier check balances will continue to decline. The cashier check balances maintained in-house by the Corporation will provide investable funds from which the Corporation will derive interest income in future periods.

Other non-interest income increased \$3.3 million, or 8.1%, for the nine months ended September 30, 2008 compared to the same period in 2007. Contributing to the increase were increases in income from check card usage (up \$1.7 million), mineral interest income (up \$1.7 million), sundry income from various miscellaneous items (up \$1.3 million) and gains on the sale of assets (up \$421 thousand). These increases were partly offset by a decrease in earnings on cashier check balances (down \$1.7 million). Sundry income for the nine months ended September 30, 2008 included \$2.4 million in income recognized from the collection of loan interest and other charges written-off in prior years. Sundry income from various miscellaneous items also included \$1.9 million recognized during the first quarter of 2008 related to the partial redemption of shares received from the VISA, Inc. initial public offering resulting from the Corporation's membership interest in VISA USA. A portion of the shares allocated to the Corporation in the initial public offering were withheld to cover the costs and liabilities associated with certain litigation for which the Corporation, based on its prior proportionate membership interest in VISA USA, is obligated to indemnify VISA under its indemnification agreement with VISA USA. The Corporation accrued \$548 thousand in connection with its obligations under the indemnification agreement during the fourth quarter of 2007. Since a portion of the shares allocated to the Corporation in the initial public offering were withheld, the Corporation was not required to make any cash payments related to the indemnification agreement. As such, the indemnification accrual related to certain pending litigation was reversed during the first quarter of 2008 and included in the aforementioned \$1.9 million of income. Additional accruals may be required in future periods should the Corporation's estimate of its obligations under the indemnification agreement change. During the first nine months of 2007 significant components of sundry income included \$2.0 million in income recognized from the collection of loan interest and other charges written-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 2008 increased \$2.4 million, or 17.9%, compared to the second quarter of 2008. Contributing to the increase were increases in sundry income from various miscellaneous items (up \$2.1 million), gains on sales of assets (up \$1.1 million) and mineral interest income (up \$623 thousand). These increases were partly offset by a decrease in gains on the sale of student loans (down \$1.0 million) and earnings on cashier check balances (down \$482 thousand). During the second quarter of 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. Sales of student loans during the third quarter of 2008 were limited as the Corporation's student loan servicer could not obtain the necessary funding required to purchase the loans. The Corporation expects to complete the sale of the remainder of the student loan portfolio in 2009.

Table of Contents**Non-Interest Expense**

The components of non-interest expense were as follows:

| | Three Months Ended | | | Nine Months Ended | |
|-------------------------|-----------------------|-------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2008 | June 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Salaries and wages | \$ 57,803 | \$ 54,534 | \$ 52,996 | \$ 167,475 | \$ 155,913 |
| Employee benefits | 10,677 | 11,912 | 10,727 | 36,702 | 37,150 |
| Net occupancy | 10,342 | 10,091 | 9,509 | 30,080 | 28,626 |
| Furniture and equipment | 9,657 | 9,182 | 8,793 | 27,789 | 23,951 |
| Intangible amortization | 1,976 | 1,955 | 2,184 | 5,977 | 6,698 |
| Other | 32,517 | 32,416 | 29,358 | 95,079 | 95,958 |
| Total | \$ 122,972 | \$ 120,090 | \$ 113,567 | \$ 363,102 | \$ 348,296 |

Total non-interest expense for the three and nine months ended September 30, 2008 increased \$9.4 million, or 8.3%, and \$14.8 million, or 4.3%, compared to the same periods in 2007. Total non-interest expense for the third quarter of 2008 increased \$2.9 million, or 2.4%, compared to the second quarter of 2008. 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, 2008 increased \$4.8 million, or 9.1%, and \$11.6 million, or 7.4%, compared to the same periods in 2007. The increases were primarily related to normal, annual merit increases, increases in headcount and increases in incentive compensation, which was partly related to higher investment banking fees from corporate advisory services and commissions related to higher insurance revenues.

Salaries and wages expense for the third quarter of 2008 increased \$3.3 million, or 6.0%, compared to the second quarter of 2008. The increase was partly related to normal, annual merit increases, increases in headcount and increases in incentive compensation related to higher investment banking fees from corporate advisory services and commissions related to higher insurance revenues.

Employee Benefits. Employee benefits expense for the three months ended September 30, 2008 did not significantly fluctuate compared to the same period in 2007 as decreases in expenses related to the Corporation's defined benefit retirement and restoration plans (down \$532 thousand) and expenses related to the Corporation's 401(k) and profit sharing plans (down \$271 thousand) were mostly offset by increases in medical insurance expense (up \$587 thousand).

Employee benefits expense for the nine months ended September 30, 2008 decreased \$448 thousand, or 1.2%, compared to the same period in 2007. The decrease was primarily related to decreases in expenses related to the Corporation's defined benefit retirement and restoration plans (down \$1.7 million) and workers compensation insurance expense (down \$254 thousand). These decreases were partially offset by increases in medical insurance expense (up \$657 thousand) and payroll taxes (up \$632 thousand).

Employee benefits expense for the third quarter of 2008 decreased \$1.2 million, or 10.4%, compared to the second quarter of 2008. The decrease is primarily due to decreases in medical expense (down \$699 thousand) as a result of lower projected medical costs, expenses related to the Corporation's 401(k) and profit sharing plans (down \$415 thousand) and payroll taxes (down \$236 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, 2008 increased \$833 thousand, or 8.8%, and \$1.5 million, or 5.1%, compared to the same periods in 2007. The increase during the three months ended September 30, 2008 was primarily related to an increase in utilities (up \$347 thousand), building maintenance (up \$145 thousand), service contracts expense (up \$117 thousand) and lease expense (up \$113 thousand). The increase during the nine months ended September 30, 2008 was primarily due to an increase in utilities (up \$606 thousand), lease expense (up \$443 thousand), building maintenance (up \$232 thousand) and service contracts expense (up \$190 thousand). Net occupancy expense for the third quarter of 2008 increased \$251 thousand, or 2.5%, compared to the second quarter of 2008.

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

primarily due to increases in utilities (up \$374 thousand) and repairs and maintenance expense (up \$89 thousand) partly offset by a decrease in lease expense (down \$211 thousand).

Furniture and Equipment. Furniture and equipment expense for the three and nine months ended September 30, 2008 increased \$864 thousand, or 9.8%, and \$3.8 million, or 16.0%, compared to the same periods in 2007. The increase during the three months ended September 30, 2008 was primarily related to increases in service contracts expense (up \$268 thousand),

Table of Contents

depreciation expense related to furniture and fixtures (up \$261 thousand) and in software maintenance expense (up \$220 thousand). The increase during the nine months ended September 30, 2008 was primarily related to increases in depreciation expense related to furniture and fixtures (up \$1.1 million), software amortization expense (up \$1.0 million), software maintenance expense (up \$861 thousand) and service contracts expense (up \$776 thousand). 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 2008 increased \$475 thousand, or 5.2%, compared to the second quarter primarily due to increases in software maintenance expense (up \$384 thousand) and depreciation expense related to furniture and fixtures (up \$108 thousand).

Intangible Amortization. Intangible amortization is primarily related to core deposit intangibles and, to a lesser extent, intangibles related to customer relationships and non-compete agreements. Intangible amortization for the three and nine months ended September 30, 2008 decreased \$208 thousand, or 9.5% and \$721 thousand, or 10.8% compared to the same periods in 2007. The decrease in amortization expense is primarily the result of a reduction in the annual amortization rate of certain intangible assets as the Corporation uses an accelerated amortization approach which results in higher amortization rates during the earlier years of the useful lives of intangible assets, as well as the completion of the amortization for certain intangible assets, partly offset by the impact of the additional amortization of intangible assets acquired in connection with the acquisition of Prime Benefits during the fourth quarter of 2007 and Seeberger during the third quarter of 2008. Intangible amortization for the third quarter of 2008 increased \$21 thousand compared to the second quarter of 2008 primarily related to the intangible assets recognized in connection with the acquisition of Seeberger.

Other Non-Interest Expense. Other non-interest expense for the three months ended September 30, 2008 increased \$3.2 million, or 10.8%, compared to the same period in 2007. Significant components of the increase included FDIC insurance expense (up \$1.6 million), sundry expense from various miscellaneous items (up \$1.4 million) and professional service expense (up \$934 thousand). The increase in FDIC insurance expense resulted as available assessment credits were mostly utilized for assessments through June 30, 2008. In October 2008, the FDIC announced its intention to seek an increase in deposit insurance premiums that, beginning in 2009, would effectively double the average insurance premiums paid by banks and thrifts to ensure that the deposit insurance fund can adequately cover projected losses from future bank failures. The Corporation cannot provide any assurance as to the amount of any projected increase in its deposit insurance premium rate, should such an increase occur, as such changes are dependent upon a variety of factors, some of which are beyond the Corporation's control. Sundry expense from various miscellaneous items during the third quarter of 2008 included a \$1.0 million accrual for costs related to Hurricane Ike which impacted the Corporation's Houston and Galveston market areas and a \$410 thousand accrual related to a probable lease settlement agreement. A portion of the increase in professional services expense was related to sub-advisor costs for Frost Investment Advisors, LLC, a newly formed registered investment advisor subsidiary of the Corporation.

Other non-interest expense for the nine months ended September 30, 2008 decreased \$879 thousand, or 0.9%, compared to the same period in 2007. Significant components of other non-interest expense with decreases compared to 2007 included sundry expense from various miscellaneous items (down \$4.3 million), armored motor service expense (down \$861 thousand), and outside computer services expense (down \$727 thousand) and depreciation expense on leased property (down \$484 thousand). Sundry expense from various miscellaneous items in 2007 included \$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 in 2007 was \$1.4 million in expense related to a contribution for previously unmatched employee contributions to the Corporation's 401(k) plan. As mentioned above, sundry expense from various miscellaneous items for 2008 included a \$1.0 million accrual for costs related to Hurricane Ike which impacted the Corporation's Houston and Galveston market areas and a \$410 thousand accrual related to a probable lease settlement agreement, both accruals recognized during the third quarter of 2008. Also included in 2008 was \$1.1 million in expense recognized in the second quarter related to a settlement, release and license agreement associated with certain patent infringement claims. The decreases in the aforementioned items were for the most part offset by increases in professional service expense (up \$2.9 million), partly related to the formation of Frost Investment Advisors, LLC, and the aforementioned settlement, and FDIC insurance expense (up \$1.9 million). As stated above, the increase in FDIC insurance expense primarily resulted as available assessment credits were mostly utilized for assessments through June 30, 2008. Additionally, a portion of the 2008 assessments prior to the third quarter were required to be paid in cash rather than be fully offset by available assessment credits.

Total other non-interest expense for the third quarter of 2008 increased \$101 thousand, or 0.3%, compared to the second quarter of 2008. Increases in FDIC insurance (up \$1.2 million) and advertising/promotions expense (up \$322 thousand) were mostly offset by decreases in meals and entertainment expense (down \$349 thousand), travel expense (down \$308 thousand) as well as less significant decreases in various other categories of non-interest expense.

Table of Contents**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, 2008 | June 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Banking | \$ 42,924 | \$ 47,702 | \$ 51,904 | \$ 140,062 | \$ 150,603 |
| Financial Management Group | 7,417 | 7,068 | 7,435 | 20,748 | 19,541 |
| Non-Banks | (1,376) | (2,223) | (2,876) | (6,518) | (12,773) |
| Consolidated net income | \$ 48,965 | \$ 52,547 | \$ 56,463 | \$ 154,292 | \$ 157,371 |

Banking

Net income for the three and nine months ended September 30, 2008 decreased \$9.0 million, or 17.3%, and \$10.5 million, or 7.0%, compared to the same periods in 2007. The decrease during the three months ended September 30, 2008 was primarily the result of a \$13.2 million increase in the provision for possible loan losses and a \$7.4 million increase in non-interest expense partly offset by a \$3.6 million increase in net interest income, a \$3.1 million increase in non-interest income and a \$4.9 million decrease in income tax expense. The decrease during the nine months ended September 30, 2008 was primarily the result of a \$18.1 million increase in the provision for possible loan losses and a \$15.2 million increase in non-interest expense partly offset by a \$8.7 million increase in non-interest income, a \$5.2 million increase in net interest income and a \$8.8 million decrease in income tax expense.

Net interest income for the three and nine months ended September 30, 2008 increased \$3.6 million, or 2.8%, and \$5.2 million, or 1.4%, from the comparable periods in 2007. During the three months ended September 30, 2008, the increase was primarily related to an increase in the average volume of earning assets and, to a lesser extent, an increase in the net interest margin. The increase for the nine months ended September 30, 2008 was primarily the result of growth in the average volume of earning assets. The increase was also due in part to a higher number of days during the period relative to 2007 due to the leap year. 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, 2008 totaled \$18.9 million and \$29.3 million compared to \$5.8 million and \$11.2 million for the same periods in 2007. During the third quarter of 2008, the Banking segment recorded a provision for possible loan losses totaling approximately \$10 million for probable loan losses related to Hurricane Ike which impacted the Corporation's Houston and Galveston market areas. 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, 2008 increased \$3.1 million, or 6.6%, and \$8.7 million, or 6.5%, compared to the same periods in 2007. The increases were due to increases in service charges on deposit accounts, other non-interest income and insurance commissions and fees partly off set by decreases in other charges, commissions and fees during both the three and nine months ended September 30, 2008. See the analysis of service charges on deposit accounts, other non-interest income, insurance commissions and fees 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, 2008 increased \$7.4 million, or 7.8%, and \$15.2 million, or 5.3%, compared to the same period in 2007. The increase was primarily related to increases in salaries and wages, furniture and equipment expense, net occupancy and other non-interest expense partly offset by decreases in employee benefits and intangible amortization. The increases in salaries and wages were primarily related to normal, annual merit increases, increases in headcount and increases in commissions and incentive compensation. The increase in furniture and equipment expense was primarily related to increases in depreciation expense related to furniture and fixtures, software amortization expense, software maintenance expense and service contracts expense. The increase in net occupancy expense was primarily due to an increase in utilities, lease expense and building maintenance. The increase in other non-interest expense included increases in sundry expense from various miscellaneous items, FDIC insurance expense, professional services expense, armored motor service expense and outside computer services expense. 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 \$8.3 million and \$26.6 million during the three and nine months ended September 30, 2008 and \$7.7 million and \$25.0 million during the same periods in 2007. Insurance commission revenues increased \$567 thousand, or 7.4%, and increased \$1.6 million, or 6.4%, during the three months and nine months ended September 30, 2008 compared to the same period in 2007. The increases during the three and nine months ended September 30, 2008 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.

Table of Contents

Financial Management Group (FMG)

Net income for the three months ended September 30, 2008 decreased \$18 thousand compared to the same period in 2007. The decrease was primarily due to a \$2.2 million increase in non-interest expense and a \$453 thousand decrease in net interest income offset by a \$2.6 million increase in non-interest income. Net income for the nine months ended September 30, 2008 increased \$1.2 million compared to the same period in 2007. The increase was primarily due to a \$6.5 million increase in non-interest income partly offset by a \$4.5 million increase in non-interest expense and a \$649 thousand increase in income tax expense.

Net interest income for the three months ended September 30, 2008 decreased \$453 thousand, or 7.8%, compared to the same period in 2007. The decrease was primarily related to a decrease in average market interest rates during the third quarter of 2008 relative to the third quarter of 2007, which impacted the funds transfer price paid on FMG's repurchase agreements. Net interest income for the nine months ended September 30, 2008 did not significantly fluctuate compared to the same period in 2007.

Non-interest income for the three and nine months ended September 30, 2008 increased \$2.6 million, or 11.4%, and \$6.5 million, or 9.6% from the comparable periods in 2007. The increase during the three months ended September 30, 2008 was primarily due to increases in trust fees (up \$2.0 million) and other charges, commissions and fees (up \$968 thousand), partially offset by a decrease in other income (down \$341 thousand). The increase during the nine months ended September 30, 2008 was primarily due to increases in trust fees (up \$4.8 million) and other charges, commissions and fees (up \$2.7 million), partially offset by a decrease in other income (down \$974 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 68% and 71% of total trust fees for the first nine months of 2008 and 2007, 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 increases in trust fee income during the three and nine months ended September 30, 2008 compared to the same periods in 2007 were primarily the result of increases in oil and gas trust management fees, investment fees and securities lending income. 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 three and nine months ended September 30, 2008 compared to the same periods in 2007 were primarily due to increases in commission income related to the sale of money market accounts, mutual funds and annuities as well as an increase in brokerage commissions.

Non-interest expense for the three and nine months ended September 30, 2008 increased \$2.2 million, or 12.7%, and \$4.5 million, or 8.4%, compared to the same periods in 2007. The increase during the three months ended September 30, 2008 was primarily due to increases in salaries and wages and employee benefits (up \$1.3 million on a combined basis) and other non-interest expense (up \$940 thousand). The increase during the nine months ended September 30, 2008 was primarily due to an increase in salaries and wages and employee benefits (up \$3.1 million on a combined basis) and other non-interest expense (up \$1.5 million). The increase in salaries and wages and employee benefits was primarily related to normal, annual merit increases, increases in headcount and increases in commissions and incentive compensation. The increase in other non-interest expense was primarily due to increases in professional service expense, in part related to sub-advisor costs for Frost Investment Advisors, LLC, a newly formed registered investment advisor subsidiary of the Corporation and component of the FMG operating segment.

Non-Banks

The net loss for the Non-Banks operating segment for the three months ended September 30, 2008 decreased \$1.5 million compared to the same period in 2007. The decrease in the net loss was primarily the result of a decrease in interest expense on certain borrowings. As market interest rates have decreased, the Non-Banks segment has experienced a corresponding decrease in interest cost related to its variable-rate junior subordinated deferrable interest debentures issued in February 2004. Additionally, the \$3.1 million of variable-rate junior subordinated deferrable interest debentures acquired in connection with the acquisition of Alamo Corporation of Texas were redeemed in the first quarter of 2008. The net loss for the Non-Banks operating segment for the nine months ended September 30, 2008 decreased \$6.3 million compared to the same period in 2007. During the first quarter of 2007, the net loss included \$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

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

The Corporation recognized income tax expense of \$21.2 million and \$67.4 million, for effective tax rates of 30.2% and 30.4% for the three and nine months ended September 30, 2008 compared to \$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. 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. The decrease in the effective tax rate during 2008 was primarily the result of an increase in holdings of tax-exempt municipal securities.

Table of Contents**Average Balance Sheet**

Average assets totaled \$13.5 billion for the nine months ended September 30, 2008 representing an increase of \$462.4 million, or 3.6%, compared to average assets for the same period in 2007. The increase was primarily reflected in earning assets, which increased \$365.6 million, or 3.2%, during the first nine months of 2008 compared to the first nine months of 2007. The increase was primarily due to a \$749.0 million, or 10.1%, increase in average loans. The loan growth was primarily funded by available liquidity as average federal funds sold and resell agreements decreased \$489.2 million, or 75.5% during 2008 compared to 2007. Average securities increased \$106.7 million, or 3.3%, to \$3.3 billion during the first nine months of 2008 from \$3.2 billion during the first nine months of 2007. Total deposits averaged \$10.4 billion for the first nine months of 2008, increasing \$203.4 million, or 2.0%, compared to the same period in 2007. Average interest-bearing accounts increased from 65.3% of average total deposits in 2007 to 65.9% of average total deposits in 2008.

Loans

Loans were as follows as of the dates indicated:

| | September 30, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 | September 30, 2007 |
|--|-----------------------|---------------------|---------------------|----------------------|-----------------------|
| Commercial and industrial: | | | | | |
| Commercial | \$ 3,815,826 | \$ 3,714,870 | \$ 3,583,588 | \$ 3,472,759 | \$ 3,234,509 |
| Leases | 198,774 | 198,814 | 189,719 | 184,140 | 182,553 |
| Asset-based | 103,400 | 74,073 | 37,261 | 32,963 | 35,879 |
| Total commercial and industrial | 4,118,000 | 3,987,757 | 3,810,568 | 3,689,862 | 3,452,941 |
| Real estate: | | | | | |
| Construction: | | | | | |
| Commercial | 677,035 | 671,010 | 635,496 | 560,176 | 580,865 |
| Consumer | 58,888 | 67,059 | 61,101 | 61,595 | 73,209 |
| Land: | | | | | |
| Commercial | 370,935 | 398,964 | 396,759 | 397,319 | 390,796 |
| Consumer | 1,892 | 1,978 | 2,189 | 2,996 | 3,631 |
| Commercial mortgages | 2,200,798 | 2,117,356 | 2,001,059 | 1,982,786 | 1,892,456 |
| 1-4 family residential mortgages | 83,099 | 87,862 | 96,978 | 98,077 | 104,073 |
| Home equity and other consumer | 688,153 | 647,790 | 607,513 | 587,721 | 559,860 |
| Total real estate | 4,080,800 | 3,992,019 | 3,801,095 | 3,690,670 | 3,604,890 |
| Consumer: | | | | | |
| Indirect | 1,382 | 1,550 | 1,805 | 2,031 | 2,324 |
| Student loans held for sale | 32,097 | 32,125 | 75,084 | 62,861 | 71,100 |
| Other | 343,723 | 326,431 | 323,143 | 323,320 | 317,045 |
| Other | 47,238 | 41,489 | 29,927 | 29,891 | 41,863 |
| Unearned discount | (27,254) | (27,870) | (28,725) | (29,273) | (29,408) |
| Total loans | \$ 8,595,986 | \$ 8,353,501 | \$ 8,012,897 | \$ 7,769,362 | \$ 7,460,755 |

Loans totaled \$8.6 billion at September 30, 2008, an increase of \$826.6 million, or 10.6%, compared to December 31, 2007. 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. During the second quarter of 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. The Corporation expects to complete the sale of the remainder of the student loan portfolio in 2009. Excluding 1-4 family residential mortgages, the indirect lending portfolio and student loans, loans increased \$873.0 million, or 11.5%, from December 31, 2007.

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 47.9% and 47.5% of total loans at September 30, 2008 and December 31, 2007 while real estate loans made up 47.5% of total

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

loans at both September 30, 2008 and December 31, 2007. Real estate loans include both commercial and consumer balances.

Commercial and industrial loans increased \$428.1 million, or 11.6%, from December 31, 2007 to September 30, 2008. The Corporation's commercial and industrial loans are a diverse group of loans to small, medium and large businesses. The purpose

Table of Contents

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 (SNCs) 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 \$501.7 million at September 30, 2008, increasing \$89.8 million, or 21.8%, from \$411.9 million at December 31, 2007. At September 30, 2008, 60.2% 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 \$4.1 billion at September 30, 2008, increasing \$390.1 million, or 10.6%, from \$3.7 billion at December 31, 2007. 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 \$405.1 million, or 11.3%, from December 31, 2007. Commercial real estate loans totaled \$3.2 billion at September 30, 2008 and represented 79.6% 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, 2008, approximately 58% 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 \$70.6 million, or 6.2%, from December 31, 2007. Excluding 1-4 family residential mortgages, indirect loans and student loans, total consumer loans increased \$117.0 million, or 12.0%, from December 31, 2007.

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, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 | September 30, 2007 |
|----------------------------------|-----------------------|------------------|-------------------|----------------------|-----------------------|
| Consumer real estate: | | | | | |
| Construction | \$ 58,888 | \$ 67,059 | \$ 61,101 | \$ 61,595 | \$ 73,209 |
| Land | 1,892 | 1,978 | 2,189 | 2,996 | 3,631 |
| Home equity loans | 315,676 | 303,507 | 290,845 | 282,947 | 272,428 |
| Home equity lines of credit | 112,662 | 101,174 | 93,287 | 86,873 | 88,223 |
| Other consumer real estate | 259,815 | 243,109 | 223,381 | 217,901 | 199,209 |
| Total consumer real estate | 748,933 | 716,827 | 670,803 | 652,312 | 636,700 |
| Consumer non-real estate | 343,723 | 326,431 | 323,143 | 323,320 | 317,045 |
| Student loans held for sale | 32,097 | 32,125 | 75,084 | 62,861 | 71,100 |
| Indirect | 1,382 | 1,550 | 1,805 | 2,031 | 2,324 |
| 1-4 family residential mortgages | 83,099 | 87,862 | 96,978 | 98,077 | 104,073 |
| Total consumer loans | \$ 1,209,234 | \$ 1,164,795 | \$ 1,167,813 | \$ 1,138,601 | \$ 1,131,242 |

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 discontinued originating 1-4 family residential mortgage loans and indirect consumer loans in 2000. Additionally, during the second quarter of 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. The Corporation expects to complete the sale of the

remainder of the student loan portfolio in 2009.

Table of Contents**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, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 | September 30, 2007 |
|--|-----------------------|------------------|-------------------|----------------------|-----------------------|
| Non-accrual loans: | | | | | |
| Commercial and industrial | \$ 24,316 | \$ 20,478 | \$ 12,516 | \$ 11,445 | \$ 12,937 |
| Real estate | 19,953 | 18,531 | 14,465 | 12,026 | 7,273 |
| Consumer and other | 1,206 | 1,476 | 1,661 | 972 | 1,146 |
| Total non-accrual loans | 45,475 | 40,485 | 28,642 | 24,443 | 21,356 |
| Foreclosed assets: | | | | | |
| Real estate | 9,101 | 8,544 | 7,305 | 4,596 | 4,278 |
| Other | 582 | 602 | 639 | 810 | 745 |
| Total foreclosed assets | 9,683 | 9,146 | 7,944 | 5,406 | 5,023 |
| Total non-performing assets | \$ 55,158 | \$ 49,631 | \$ 36,586 | \$ 29,849 | \$ 26,379 |
| Non-performing assets as a percentage of: | | | | | |
| Total loans and foreclosed assets | 0.64% | 0.59% | 0.46% | 0.38% | 0.35% |
| Total assets | 0.39 | 0.36 | 0.27 | 0.22 | 0.20 |
| Accruing past due loans: | | | | | |
| 30 to 89 days past due | \$ 66,378 | \$ 56,721 | \$ 53,936 | \$ 45,290 | \$ 54,747 |
| 90 or more days past due | 7,819 | 11,898 | 17,563 | 14,347 | 10,940 |
| Total accruing past due loans | \$ 74,197 | \$ 68,619 | \$ 71,499 | \$ 59,637 | \$ 65,687 |
| Ratio of accruing past due loans to total loans: | | | | | |
| 30 to 89 days past due | 0.77% | 0.68% | 0.67% | 0.58% | 0.73% |
| 90 or more days past due | 0.09 | 0.14 | 0.22 | 0.19 | 0.15 |
| Total accruing past due loans | 0.86% | 0.82% | 0.89% | 0.77% | 0.88% |

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.

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, 2008 and December 31, 2007, the Corporation had \$42.4 million and \$30.3 million in loans of this type which are not included in either of the non-accrual or 90 days past due loan categories. At September 30, 2008, potential problem loans consisted of eleven credit relationships. Of the total outstanding balance at September 30, 2008, approximately 62.3% related to eight customers in the real estate lot development/single-family residential construction industry and approximately 28.6% related to a customer in the credit collections industry. Weakness in these companies' operating performance

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

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 \$418 thousand and \$1.0 million for the three and nine months ended September 30, 2008, compared to \$537 thousand and \$2.0 million for the same periods in 2007.

Table of Contents**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, 2008 | June 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Balance at beginning of period | \$ 94,520 | \$ 92,498 | \$ 96,071 | \$ 92,339 | \$ 96,085 |
| Provision for possible loan losses | 18,940 | 6,328 | 5,784 | 29,273 | 11,084 |
| Charge-offs: | | | | | |
| Commercial and industrial | (5,261) | (2,279) | (2,124) | (11,297) | (5,604) |
| Real estate | (697) | (2,436) | (7,535) | (4,215) | (8,696) |
| Consumer and other | (2,135) | (1,824) | (2,080) | (5,786) | (5,577) |
| Total charge-offs | (8,093) | (6,539) | (11,739) | (21,298) | (19,877) |
| Recoveries: | | | | | |
| Commercial and industrial | 479 | 968 | 966 | 2,607 | 1,666 |
| Real estate | 43 | 17 | 120 | 473 | 250 |
| Consumer and other | 1,220 | 1,248 | 1,061 | 3,715 | 3,055 |
| Total recoveries | 1,742 | 2,233 | 2,147 | 6,795 | 4,971 |
| Net charge-offs | (6,351) | (4,306) | (9,592) | (14,503) | (14,906) |
| Balance at end of period | \$ 107,109 | \$ 94,520 | \$ 92,263 | \$ 107,109 | \$ 92,263 |
| Ratio of allowance for possible loan losses to: | | | | | |
| Total loans | 1.25% | 1.13% | 1.24% | 1.25% | 1.24% |
| Non-accrual loans | 235.53 | 233.47 | 432.02 | 235.53 | 432.02 |
| Ratio of annualized net charge-offs to average total loans | 0.30 | 0.21 | 0.51 | 0.24 | 0.27 |

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 determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. The provision for possible loan losses reflects loan quality trends, including the levels of and trends related to 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 \$18.9 million and \$29.3 million for the three and nine months ended September 30, 2008, compared to \$5.8 million and \$11.1 million for the three and nine months ended September 30, 2007. The provision for possible loan losses increased by \$18.2 million, or 164.1%, during the nine months ended September 30, 2008 compared to the same period in 2007 primarily as a result of a provision totaling approximately \$10 million for probable loan losses related to Hurricane Ike which impacted the Corporation's Houston and Galveston market areas during the third quarter of 2008. In determining the amount of the provision, the Corporation identified customers that were likely impacted by the hurricane based on their geographic location. The Corporation adjusted risk grades for loans to these customers based on estimated loan payment abilities and loss of collateral value. Furthermore, the Corporation increased the historical loss allocation factors for all lower-risk, pass loans to customers within the areas directly impacted by Hurricane Ike and the greater Houston/Galveston market area as a whole. The increase in the provision for possible loan losses was also partly due to an increase in classified loans and the overall growth in loans, which increased \$826.6 million, or 10.6% during the first nine months of 2008. During the third quarter of

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

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

Table of Contents

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 allowance 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 increased 6 basis points from 1.19% at December 31, 2007 to 1.25% at September 30, 2008. 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, particularly as it relates to the Corporation's assessment of probable losses resulting from the impact of Hurricane Ike.

Capital and Liquidity

Capital. At September 30, 2008, shareholders' equity totaled \$1.6 billion compared to \$1.5 billion at December 31, 2007 and \$1.4 billion at September 30, 2007. In addition to net income of \$154.3 million, other significant changes in shareholders' equity during the first nine months of 2008 included \$73.2 million of dividends paid, \$21.9 million in treasury stock purchases, \$34.5 million in proceeds from stock option exercises and the related tax benefits of \$7.8 million and \$7.4 million related to stock-based compensation. The accumulated other comprehensive income component of shareholders' equity totaled \$17.8 million at September 30, 2008 compared to an accumulated other comprehensive loss of \$7.4 million at December 31, 2007. This fluctuation was primarily related to the after-tax effect of an increase in the accumulated net gain on effective cash flow hedges during the first nine months of 2008 combined with the after-tax effect of a decrease in the unrealized gain/loss on securities available for sale. Under regulatory requirements, amounts reported as accumulated other comprehensive income/loss related to the accumulated net gain/loss on effective cash flow hedges, 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 \$0.40, \$0.42 and \$0.42 per common share during the first, second and third quarters of 2008 and quarterly dividends of \$0.34, \$0.40 and \$0.40 per common share during the first, second and third quarters of 2007. This equates to a dividend payout ratio of 50.8% and 47.4% during the three and nine months ended September 30, 2008 and 41.4% and 42.8% during the three and nine months ended September 30, 2007.

From time to time, the Corporation's board of directors has authorized stock repurchase plans. 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 most recent 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 2.1 million shares at a total cost of \$109.4 million during 2007, while the remaining 404 thousand shares approved for repurchase were repurchased during the first quarter of 2008 at a total cost of \$21.9 million. See Part II, Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds, included elsewhere in this report, for details of stock repurchases during the quarter.

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 and Federal Home Loan Bank advances.

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. Under

these dividend

Table of Contents

restrictions, and without adversely affecting its well capitalized status, Frost Bank could pay aggregate dividends of approximately \$265.0 million to Cullen/Frost, without obtaining affirmative regulatory approvals, at September 30, 2008. At September 30, 2008, Cullen/Frost had liquid assets, including cash and securities purchased under resell agreements, totaling \$86.7 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, 2008.

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 January 7, 2008, the Corporation redeemed \$3.1 million of floating rate (three-month LIBOR plus a margin of 3.30%) junior subordinated deferrable interest debentures, due January 7, 2033, held of record by Alamo Trust. Concurrently, the \$3.0 million of floating rate (three-month LIBOR plus a margin of 3.30%) trust preferred securities issued by Alamo Trust were also redeemed. See Note 9 - Borrowed Funds for additional information.

Recently Issued Accounting Pronouncements

See Note 18- 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.

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis Year-to-Date**

(dollars in thousands taxable-equivalent basis)

| | September 30, 2008 | | | September 30, 2007 | | |
|---|----------------------|--------------------------------|----------------|----------------------|--------------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Cost | Average Balance | Interest Income/ Expense | Yield/ Cost |
| Assets: | | | | | | |
| Interest-bearing deposits | \$ 6,009 | \$ 141 | 3.13% | \$ 6,935 | \$ 272 | 5.25% |
| Federal funds sold and resell agreements | 158,338 | 3,284 | 2.77 | 647,525 | 25,529 | 5.27 |
| Securities: | | | | | | |
| Taxable | 2,806,662 | 109,234 | 5.19 | 2,845,939 | 110,271 | 5.06 |
| Tax-exempt | 526,214 | 25,461 | 6.46 | 380,192 | 18,366 | 6.41 |
| Total securities | 3,332,876 | 134,695 | 5.39 | 3,226,131 | 128,637 | 5.22 |
| Loans, net of unearned discounts | 8,180,720 | 384,817 | 6.28 | 7,431,707 | 436,988 | 7.86 |
| Total Earning Assets and Average Rate Earned | 11,677,943 | 522,937 | 5.98 | 11,312,298 | 591,426 | 6.95 |
| Cash and due from banks | 638,395 | | | 612,942 | | |
| Allowance for possible loan losses | (93,318) | | | (96,261) | | |
| Premises and equipment | 231,598 | | | 220,150 | | |
| Accrued interest receivable and other assets | 1,008,738 | | | 951,851 | | |
| Total Assets | \$ 13,463,356 | | | \$ 13,000,980 | | |
| Liabilities: | | | | | | |
| Non-interest-bearing demand deposits: | | | | | | |
| Commercial and individual | \$ 3,205,603 | | | \$ 3,244,814 | | |
| Correspondent banks | 292,367 | | | 241,767 | | |
| Public funds | 53,431 | | | 51,406 | | |
| Total non-interest-bearing demand deposits | 3,551,401 | | | 3,537,987 | | |
| Interest-bearing deposits: | | | | | | |
| Private accounts | | | | | | |
| Savings and interest checking | 1,672,056 | 2,510 | 0.20 | 1,358,534 | 5,099 | 0.50 |
| Money market deposit accounts | 3,468,862 | 41,094 | 1.58 | 3,508,423 | 83,964 | 3.20 |
| Time accounts | 1,337,268 | 34,401 | 3.44 | 1,370,162 | 44,706 | 4.36 |
| Public funds | 374,517 | 5,457 | 1.95 | 425,629 | 13,128 | 4.12 |
| Total interest-bearing deposits | 6,852,703 | 83,462 | 1.63 | 6,662,748 | 146,897 | 2.95 |
| Total deposits | 10,404,104 | | | 10,200,735 | | |
| Federal funds purchased and repurchase agreements | 934,063 | 10,954 | 1.57 | 849,814 | 24,453 | 3.85 |
| Junior subordinated deferrable interest debentures | 136,152 | 5,234 | 5.13 | 158,436 | 8,740 | 7.36 |
| Subordinated notes payable and other borrowings | 250,000 | 12,238 | 6.53 | 233,516 | 11,511 | 6.57 |
| Federal Home Loan Bank advances | 9,316 | 402 | 5.76 | 26,243 | 899 | 4.58 |
| Total Interest-Bearing Funds and Average Rate Paid | 8,182,234 | 112,290 | 1.83 | 7,930,757 | 192,500 | 3.24 |
| Accrued interest payable and other liabilities | 171,758 | | | 148,803 | | |

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

| | | |
|---|----------------------|----------------------|
| Total Liabilities | 11,905,393 | 11,617,547 |
| Shareholders' Equity | 1,557,963 | 1,383,433 |
| Total Liabilities and Shareholders' Equity | \$ 13,463,356 | \$ 13,000,980 |
| Net interest income | \$ 410,647 | \$ 398,926 |
| Net interest spread | 4.15% | 3.71% |
| Net interest income to total average earning assets | 4.69% | 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.

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis By-Quarter**

(dollars in thousands taxable-equivalent basis)

| | September 30, 2008 | | | June 30, 2008 | | |
|---|----------------------|--------------------------------|----------------|----------------------|--------------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Cost | Average Balance | Interest Income/ Expense | Yield/ Cost |
| Assets: | | | | | | |
| Interest-bearing deposits | \$ 4,760 | \$ 21 | 1.76% | \$ 5,934 | \$ 47 | 3.19% |
| Federal funds sold and resell agreements | 66,339 | 344 | 2.06 | 143,625 | 802 | 2.25 |
| Securities: | | | | | | |
| Taxable | 2,671,146 | 35,233 | 5.22 | 2,849,656 | 36,803 | 5.19 |
| Tax-exempt | 534,827 | 8,732 | 6.48 | 530,209 | 8,453 | 6.47 |
| Total securities | 3,205,973 | 43,965 | 5.43 | 3,379,865 | 45,256 | 5.39 |
| Loans, net of unearned discounts | 8,434,464 | 127,265 | 6.00 | 8,187,370 | 124,645 | 6.12 |
| Total Earning Assets and Average Rate Earned | 11,711,536 | 171,595 | 5.82 | 11,716,794 | 170,750 | 5.86 |
| Cash and due from banks | 616,544 | | | 649,457 | | |
| Allowance for possible loan losses | (95,333) | | | (92,720) | | |
| Premises and equipment | 243,524 | | | 230,336 | | |
| Accrued interest receivable and other assets | 1,009,457 | | | 1,014,474 | | |
| Total Assets | \$ 13,485,728 | | | \$ 13,518,341 | | |
| Liabilities: | | | | | | |
| Non-interest-bearing demand deposits: | | | | | | |
| Commercial and individual | \$ 3,240,146 | | | \$ 3,200,533 | | |
| Correspondent banks | 307,133 | | | 280,274 | | |
| Public funds | 57,235 | | | 50,506 | | |
| Total non-interest-bearing demand deposits | 3,604,514 | | | 3,531,313 | | |
| Interest-bearing deposits: | | | | | | |
| Private accounts | | | | | | |
| Savings and interest checking | 1,695,561 | 732 | 0.17 | 1,699,880 | 750 | 0.18 |
| Money market deposit accounts | 3,482,845 | 11,988 | 1.37 | 3,468,094 | 12,092 | 1.40 |
| Time accounts | 1,282,443 | 9,125 | 2.83 | 1,334,875 | 11,297 | 3.40 |
| Public funds | 336,310 | 1,373 | 1.62 | 382,219 | 1,631 | 1.72 |
| Total interest-bearing deposits | 6,797,159 | 23,218 | 1.36 | 6,885,068 | 25,770 | 1.51 |
| Total deposits | 10,401,673 | | | 10,416,381 | | |
| Federal funds purchased and repurchase agreements | 949,309 | 2,976 | 1.25 | 958,343 | 2,954 | 1.24 |
| Junior subordinated deferrable interest debentures | 136,084 | 1,537 | 4.52 | 136,084 | 1,591 | 4.68 |
| Subordinated notes payable and other borrowings | 250,000 | 4,079 | 6.53 | 250,000 | 4,079 | 6.53 |
| Federal Home Loan Bank advances | 8,839 | 130 | 5.85 | 9,087 | 133 | 5.89 |
| Total Interest-Bearing Funds and Average Rate Paid | 8,141,391 | 31,940 | 1.56 | 8,238,582 | 34,527 | 1.68 |
| Accrued interest payable and other liabilities | 167,154 | | | 175,940 | | |

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

| | | |
|---|----------------------|----------------------|
| Total Liabilities | 11,913,059 | 11,945,835 |
| Shareholders' Equity | 1,572,669 | 1,572,506 |
| Total Liabilities and Shareholders' Equity | \$ 13,485,728 | \$ 13,518,341 |
| Net interest income | \$ 139,655 | \$ 136,223 |
| Net interest spread | 4.26% | 4.18% |
| Net interest income to total average earning assets | 4.74% | 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.

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis By-Quarter**

(dollars in thousands taxable-equivalent basis)

| | March 31, 2008 | | | December 31, 2007 | | |
|---|----------------------|--------------------------------|----------------|----------------------|--------------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Cost | Average Balance | Interest Income/ Expense | Yield/ Cost |
| Assets: | | | | | | |
| Interest-bearing deposits | \$ 7,345 | \$ 73 | 4.00% | \$ 8,994 | \$ 124 | 5.47% |
| Federal funds sold and resell agreements | 266,060 | 2,138 | 3.23 | 379,484 | 4,366 | 4.56 |
| Securities: | | | | | | |
| Taxable | 2,900,671 | 37,198 | 5.15 | 2,966,132 | 38,196 | 5.11 |
| Tax-exempt | 513,512 | 8,275 | 6.43 | 506,716 | 8,154 | 6.43 |
| Total securities | 3,414,183 | 45,473 | 5.34 | 3,472,848 | 46,350 | 5.30 |
| Loans, net of unearned discounts | 7,917,536 | 132,906 | 6.75 | 7,560,382 | 142,039 | 7.45 |
| Total Earning Assets and Average Rate Earned | 11,605,124 | 180,590 | 6.25 | 11,421,708 | 192,879 | 6.70 |
| Cash and due from banks | 649,424 | | | 665,754 | | |
| Allowance for possible loan losses | (91,879) | | | (92,157) | | |
| Premises and equipment | 220,804 | | | 219,053 | | |
| Accrued interest receivable and other assets | 998,182 | | | 954,184 | | |
| Total Assets | \$ 13,381,655 | | | \$ 13,168,542 | | |
| Liabilities: | | | | | | |
| Non-interest-bearing demand deposits: | | | | | | |
| Commercial and individual | \$ 3,175,749 | | | \$ 3,165,177 | | |
| Correspondent banks | 289,530 | | | 268,840 | | |
| Public funds | 52,511 | | | 49,001 | | |
| Total non-interest-bearing demand deposits | 3,517,790 | | | 3,483,018 | | |
| Interest-bearing deposits: | | | | | | |
| Private accounts | | | | | | |
| Savings and interest checking | 1,620,468 | 1,028 | 0.26 | 1,528,748 | 1,456 | 0.38 |
| Money market deposit accounts | 3,455,492 | 17,014 | 1.98 | 3,453,993 | 23,522 | 2.70 |
| Time accounts | 1,395,089 | 13,979 | 4.03 | 1,419,934 | 15,558 | 4.35 |
| Public funds | 405,444 | 2,453 | 2.43 | 362,277 | 2,804 | 3.07 |
| Total interest-bearing deposits | 6,876,493 | 34,474 | 2.02 | 6,764,952 | 43,340 | 2.54 |
| Total deposits | 10,394,283 | | | 10,247,970 | | |
| Federal funds purchased and repurchase agreements | 894,371 | 5,024 | 2.26 | 918,599 | 7,498 | 3.24 |
| Junior subordinated deferrable interest debentures | 136,288 | 2,106 | 6.18 | 139,177 | 2,543 | 7.31 |
| Subordinated notes payable and other borrowings | 250,000 | 4,080 | 6.53 | 250,000 | 4,080 | 6.53 |
| Federal Home Loan Bank advances | 10,028 | 139 | 5.57 | 11,183 | 149 | 5.28 |
| Total Interest-Bearing Funds and Average Rate Paid | 8,167,180 | 45,823 | 2.25 | 8,083,911 | 57,610 | 2.83 |
| Accrued interest payable and other liabilities | 168,135 | | | 172,202 | | |

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

| | | |
|---|----------------------|----------------------|
| Total Liabilities | 11,853,105 | 11,739,131 |
| Shareholders' Equity | 1,528,550 | 1,429,411 |
| Total Liabilities and Shareholders' Equity | \$ 13,381,655 | \$ 13,168,542 |
| Net interest income | \$ 134,767 | \$ 135,269 |
| Net interest spread | 4.00% | 3.87% |
| Net interest income to total average earning assets | 4.67% | 4.70% |

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.

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis By-Quarter**

(dollars in thousands taxable-equivalent basis)

| | September 30, 2007 | | |
|---|----------------------|--------------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Cost |
| Assets: | | | |
| Interest-bearing deposits | \$ 8,749 | \$ 99 | 4.49% |
| Federal funds sold and resell agreements | 713,418 | 9,288 | 5.17 |
| Securities: | | | |
| Taxable | 2,733,002 | 35,675 | 5.08 |
| Tax-exempt | 449,162 | 7,312 | 6.42 |
| Total securities | 3,182,164 | 42,987 | 5.26 |
| Loans, net of unearned discounts | 7,435,690 | 146,580 | 7.82 |
| Total Earning Assets and Average Rate Earned | 11,340,021 | 198,954 | 6.92 |
| Cash and due from banks | 602,798 | | |
| Allowance for possible loan losses | (95,992) | | |
| Premises and equipment | 220,926 | | |
| Accrued interest receivable and other assets | 957,770 | | |
| Total Assets | \$ 13,025,523 | | |
| Liabilities: | | | |
| Non-interest-bearing demand deposits: | | | |
| Commercial and individual | \$ 3,269,084 | | |
| Correspondent banks | 247,372 | | |
| Public funds | 50,614 | | |
| Total non-interest-bearing demand deposits | 3,567,070 | | |
| Interest-bearing deposits: | | | |
| Private accounts | | | |
| Savings and interest checking | 1,325,966 | 1,776 | 0.53 |
| Money market deposit accounts | 3,630,638 | 29,072 | 3.18 |
| Time accounts | 1,363,571 | 15,023 | 4.37 |
| Public funds | 364,681 | 3,570 | 3.88 |
| Total interest-bearing deposits | 6,684,856 | 49,441 | 2.93 |
| Total deposits | 10,251,926 | | |
| Federal funds purchased and repurchase agreements | 852,338 | 7,981 | 3.71 |
| Junior subordinated deferrable interest debentures | 139,177 | 2,548 | 7.32 |
| Subordinated notes payable and other borrowings | 250,000 | 4,079 | 6.53 |
| Federal Home Loan Bank advances | 16,467 | 201 | 4.84 |
| Total Interest-Bearing Funds and Average Rate Paid | 7,942,838 | 64,250 | 3.21 |
| Accrued interest payable and other liabilities | 152,953 | | |

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

| | |
|---|----------------------|
| Total Liabilities | 11,662,861 |
| Shareholders' Equity | 1,362,662 |
| Total Liabilities and Shareholders' Equity | \$ 13,025,523 |

Net interest income \$ 134,704

Net interest spread 3.71%

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.

Table of Contents

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 2007 Form 10-K. There has been no significant change in the types of market risks faced by the Corporation since December 31, 2007.

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, 2008, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 0.2% and 0.3% relative to the base case over the next 12 months, while a decrease in interest rates of 100 basis points would result in a negative variance in net interest income of 1.6% relative to the base case over the next 12 months. The likelihood of a 200 basis point decrease in interest rates as of September 30, 2008 was considered to be remote given current interest rate levels. 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.

During the fourth quarter of 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 swap 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. These actions were partly responsible for the decrease in the Corporation's sensitivity to changes in interest rates during the first nine months of 2008 compared to the same period in 2007. See Note 17 - Derivative Financial Instruments in the 2007 Form 10-K. The impact of a projected increase in interest rates was further limited as of September 30, 2008 as the Corporation increased its net average federal funds purchased position and repurchase agreements to fund loan growth during the first nine months of 2008. The Corporation's securities portfolio and approximately half of its loan portfolio will not reprice as readily with interest rate changes due to their fixed rates or the effect of the aforementioned hedge. The benefit of an increase in interest rates derived from an upward repricing of the remaining variable rate loans is mostly offset by the effect of an assumed upward repricing of the Corporation's funding sources.

As of September 30, 2008, the effect of a 200 basis point increase in interest rates on the Corporation's derivative holdings would result in a 2.1% 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 2.2% positive 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 19 "Subsequent Event" in the accompanying notes to consolidated financial statements included elsewhere in this report, on October 16, 2008, the Corporation entered into an interest rate swap contract with a total notional amount of \$120.0 million. The interest rate swap contract was designated as a hedging instrument in a cash flow hedge with the objective of protecting the quarterly interest payments on the Corporation's \$120.0 million of junior subordinated deferrable interest debentures issued to Cullen/Frost Capital Trust II throughout the five-year period beginning on December 1, 2008 and ending on December 1, 2013 from the risk of variability of those payments resulting from changes in the three-month LIBOR interest rate. The terms of the interest rate swap contract provide that the Corporation will pay a fixed interest rate of 5.47% over the term of the contract and receive a variable interest rate of three-month LIBOR plus a margin of 1.55% on a total notional amount of \$120.0 million, with quarterly settlements. The interest rate swap was entered into on October 16, 2008 at current market rates. Accordingly, no premium was paid or received in connection with the swap.

Table of Contents

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.

Table of Contents

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

Except for the addition of the risk factor detailed below, there has been no material change in the risk factors previously disclosed under Item 1A. of the Corporation's 2007 Form 10-K.

The Corporation May Be Adversely Affected By The Soundness Of Other Financial Institutions

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. The Corporation has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose the Corporation to credit risk in the event of a default by a counterparty or client. In addition, the Corporation's credit risk may be exacerbated when the collateral held by the Corporation cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to the Corporation. Any such losses could have a material adverse affect on the Corporation's financial condition and results of operations.

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

There were no 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, 2008.

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

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

| 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.

Table of Contents

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 22, 2008

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)