CULLEN/FROST

YEAR **BANKERS, INC.** 2006

ANNUAL REPORT

A TEXAS FINANCIAL SERVICES FAMILY

Cullen/Frost Bankers, Inc.

Cullen/Frost Bankers, Inc.

(NYSE: CFR)

is a financial holding company, headquartered in San Antonio, with assets of $13.2 billion at December 31, 2006. The corporation provides a full range of commercial and consumer banking products, investment and brokerage services, insurance products and investment banking services. Its subsidiary, Frost Bank, operates more than 100 financial centers across Texas in the Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio regions. Founded in 1868, Frost is one of the largest banks headquartered in Texas, with a legacy of helping Texans with their financial needs during three centuries.

The Annual Meeting of Shareholders

APRIL 26, 2007

Frost National Bank / 100 West Houston Street / San Antonio, Texas

11 A.M. IN THE COMMANDERS ROOM

Cullen/Frost Bankers, Inc.

CORPORATE HEADQUARTERS

100 West Houston Street
San Antonio, Texas 78205

(210) 220-4011
frostbank@frostbank.com

www.frostbank.com

Certifications

The certifications of the Chief Executive Officer and the Chief Financial Officer of Cullen/Frost Bankers, Inc., required under Section 302 of the Sarbanes-Oxley Act of 2002, have been filed as exhibits to Cullen/Frost's 2006 Annual Report on Form 10-K. In addition, the certification of the Chief Executive Officer of Cullen/Frost, required under the rules of the New York Stock Exchange, Inc., has been filed with the Exchange.

Form 10-K and Investor Inquiries

Analysts, investors and others desiring additional financial data about Cullen/Frost Bankers, Inc. may contact Greg Parker, Executive Vice President, Director of Investor Relations, at (210) 220-5632.

TRANSFER AGENT AND REGISTRAR

Bank of New York

101 Barclay Street / No. 12 East / New York, NY 10286 / 1-800-524-4458

Financial Highlights

2006

DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS

	2006	2005
NET INCOME	$ 193,591	$ 165,423
PER COMMON SHARE DATA		
Net Income – Basic	$ 3.49	$ 3.15
Net Income – Diluted	3.42	3.07
Cash Dividends	1.32	1.165
Book Value	23.01	18.03
PERFORMANCE RATIOS		
Return on Average Assets	1.67 %	1.63 %
Return on Average Equity	18.03	18.78
Net Interest Margin	4.67	4.45
Dividend Pay-out Ratio	37.91	37.18
YEAR-END BALANCE SHEET DATA		
Loans	$ 7,373,384	$ 6,085,055
Securities	3,350,455	3,078,029
Earning Assets	11,460,741	10,203,497
Total Assets	13,224,189	11,741,437
Non-interest-bearing Demand Deposits	3,699,701	3,484,932
Interest-bearing Deposits	6,688,208	5,661,462
Total Deposits	10,387,909	9,146,394
Long-term Debt and Other Borrowings	428,636	415,422
Shareholders' Equity	1,376,883	982,236

To Our Shareholders:

As we begin our 140th year of business, I am very pleased to tell you that this year our company achieved a level of growth—both in profitability and in physical expansion—that our founder could never have imagined when he opened his doors for business in 1868. Today, we are known as one of the best midsize banking companies in America, a strong regional financial services franchise, with a branch network of more than 100 locations in all the key markets in Texas, and assets of $13.2 billion. The growth and expansion our organization experienced this year were both deep and wide.

In 2006, the fundamentals continued to be extremely strong for our company. From a geographical standpoint, we are exactly where we want to be, with financial centers, insurance operations and other key services in all the Texas growth markets, representing 70 percent of the state's population.

Cullen/Frost again reached record levels of profitability, as we reported $193.6 million in annual earnings, or $3.42 per diluted common share, a 17 percent increase over year-end 2005. Highlighting this strong financial performance, we achieved all-time highs in both loans and deposits, reporting $7.4 billion in loans and $10.4 billion in deposits at year-end. Trust assets topped $20 billion for the first time, ending the year at $23.2 billion, while company assets also reached an all-time high of $13.2 billion. Non-interest income was $240.7 million, also a new high for our company. Net interest margin was 4.67 percent, the highest level since 2001.

External acknowledgment of our achievements is always rewarding to see, and this year, Bank Director magazine recognized Cullen/Frost's strong performance, ranking us No. 7 among the nation's top 150 banks, based on return on average assets and equity, capitalization and asset quality.

During 2006, we completed three acquisitions totaling more than $1.8 billion that significantly expanded our strength and broadened our customer base in key markets. In February, we acquired Texas Community Bancshares, Inc. in Dallas, a single-location bank with $132 million in assets and a strong private client services and commercial banking network that fits well with our Dallas operations. The following month, we finalized the acquisition of Alamo Corporation of Texas, a $308.4-million bank with 10 locations in the Rio Grande Valley. The June conversion of Alamo Bank of Texas to Frost Bank greatly expanded our distribution network in the Valley, a market we have served since 1995. And in December, we completed the acquisition of Summit Bancshares, Inc., which greatly deepened and expanded our already-strong presence in the dynamic Tarrant County region, which includes Fort Worth. With the addition of this $1.1-billion company and 10 banking locations, Tarrant County becomes Frost Bank's largest lending market and our second-largest deposit market.

Consistent with previous acquisitions, the three banking companies that merged with Frost this year are all a great fit. We share a values-based culture and approach to service that focus on taking good care of our customers and helping them with all of their financial needs.

At the same time, these acquisitions placed enormous challenges on our staff, adding significant responsibilities to a full workload. As they always do whenever we need them to step up, our employees met this challenge with superb performance, enthusiasm and dedication. They completed system conversions for all three acquisitions, while staying true to our core values, relationship banking focus and commitment to achieving our company's goals.

Throughout the year, we have worked to improve our team selling discipline, as we have come to understand that success needs to be measured not only by what an individual accomplishes in his or her own portfolio, but also by success in referring customers to other areas of the company. Our ongoing efforts to bring together other lines of business, as appropriate, to provide solutions and to help customers reach their financial goals, are helping to make us a stronger and more profitable company.

Our sales approach has become very targeted and specific, and we are seeing results. We know that our profitability doesn't come from any one source, but rather is incremental, with one success stacking on another, producing better results for both Cullen/Frost and our customers—which is the essence of relationship banking. We also know that focusing on the continued growth and profitability of this company will allow us to succeed in the long run.

We ended the year with an all-time high in loans, and although there was some flattening of loan growth during the third and fourth quarters, a strong performance during the final month of the year—combined with acquisitions—boosted our year-end loans 21.1 percent to a record $7.4 billion. Because of the fierce competition in all of the Texas markets we serve, the average commercial yield spread has declined, and our customers have benefited from this competition. We are delivering real value to our customers, offering outstanding pricing, products and service, and competing effectively without compromising loan quality.

Continuing our tradition of offering innovative banking products, we introduced Remote Deposit Capture, a new service that offers a secure and convenient way for business customers to make deposits in their offices, without having to go to the bank. Through this service, digital images of checks received in payment are captured and transmitted to Frost electronically right from a customer's office. You may recall that following 9/11, and the disruption in check exchanges caused by the grounding of all aircraft for three days after the attacks, Congress enacted landmark legislation, Check Clearing for the 21st Century. One of the technologies made possible by Check 21 was the ability to electronically clear checks between banks without the need to physically present them. This technology has been taken to the next step with Remote Deposit Capture, and the product is finding enthusiastic acceptance with many of our commercial clients.

We are beginning to see some success with our commercial prospecting initiative, in which we strategically contact key commercial prospects on a regular basis with relevant material that helps them understand the value we can add to a banking relationship.

Our commercial leasing company, Frost Leasing, was listed among the nation's top leasing companies in 2006, confirming its growing success. The Monitor, a publication for equipment leasing professionals, profiled Frost Leasing in the issue where Frost Leasing made its top 100 list for the first time. This division, which we established in 2002, has continued to produce good revenue for our company.

"OUR SALES APPROACH HAS BECOME VERY TARGETED AND SPECIFIC, AND WE ARE SEEING RESULTS."

And we continue to leverage our commercial relationships with our Bank at Work program, simplifying the process of signing up business customers' employees for consumer banking and beginning new relationships.

With our commercial customers, we are proud of our ability to take care of a company at any stage of its business life. Whether it's a start-up, a company with unique financing needs, a business making acquisitions or dealing with succession issues, or a growing company with changing insurance needs, we take a comprehensive, holistic approach and offer solutions that are right for that particular need.

Our strong deposit base continues to provide us with a key funding advantage, with our efforts throughout the year to grow deposits—along with acquisitions—resulting in a 13.6 percent increase in deposits, to $10.4 billion at year-end. Strong growth in both loans and deposits has resulted in a loan-to-deposit ratio of 71 percent for the year. This ratio, which is lower than our peers, gives us a sustainable business model and provides us with liquidity and money to loan. The percentage of demand deposits and interest-on-checking accounts to total deposits has grown over the past five years from 44 percent to 48 percent, which provides us with a low-cost funding base and allows us to be competitive on the percentage of accounts paying market rates.

Over the past two years, we have been meeting the challenge of both loan and deposit pricing, without losing sight of profitability. More competitive rates brought in new consumer business and gave our bankers another tool to effectively serve our customers. We continue to see results from our consumer on-boarding program, which provides a disciplined and effective way for us to contact new customers regularly during the first 12 months after they open their Frost accounts. This strengthening and deepening of customer relationships is consistent with our way of doing business, focusing on helping people, not on transactions. This same approach has helped us succeed with our strong referral program.

We have developed a strategic approach to opening new financial centers, not only in identifying the best locations, but also in establishing relationships and community ties well before we open our doors. During the year, we broke ground on four new locations and added 21 new financial centers through the acquisition process. In the spring, we will open a new location in Brownsville in the Rio Grande Valley—our first in that city—and one in the fast-growing Stone Oak area of San Antonio. During the first quarter, we will also open a new three-level regional office for the Valley in Alamo, Texas, as well as a new two-story location in San Antonio, Park North, which will replace our Central Park location. Concurrently, we are refurbishing existing locations and adding Internet kiosks.

To keep pace with growth initiatives, we have revamped our direct marketing approach and will expand its analytical capabilities going forward in 2007. We are also in the process of enhancing the value proposition of our consumer checking accounts and will be introducing these changes in 2007.

“We have been meeting the challenge of both loan and deposit pricing, without losing sight of profitability.”

Technology continues to be a significant driver in our commitment to remaining competitive. Even with declining check volumes nationwide, our Texas Processing Centers in San Antonio, Houston and Dallas process more than one million checks a day. At the same time, we were early adopters of image-exchange and remote deposit capture technology, and we continue to be a leader in the image exchange world.

Early in 2006, we finalized the process of moving our core data processing operations in-house, which allowed us to better integrate our mainframe and client server applications. It also resulted in significant savings in outsourcing costs during the year.

The investment we made in building an Internet banking infrastructure several years ago continues to see good results. At year-end, 55 percent of our consumer customers and 35 percent of business customers were using My Frost, our online banking service. Since security is always a priority for us, we also upgraded our authentication process for My Frost this year.

When you take a look at key factors to our success, profitability and growth are both standouts. Our net interest income represents the largest percentage of our total revenue, and it has been rising because of a higher rate environment—a plus for an asset-sensitive company like Cullen/Frost—as well as increased loan growth. Our diversified lines of business generate substantial fee income, which helps to mitigate interest rate volatility.

Non-interest income reached $240.7 million in 2006, representing 34 percent of our total revenue —higher than most of our peer banks. Over the years, we have created the framework for a steady stream of income by building our trust department, our insurance subsidiary, our treasury management services and a variety of other profitable businesses that deepen our customer relationships.

As a key component of our fee income, our Financial Management Group continues to turn in strong results. Trust assets rose to $23.2 billion in 2006, with strong support from Frost Investment Services and Wealth Management Services. John Eadie, who heads our Wealth Management Services, was once again named to Worth Magazine's list of top 100 wealth advisors for 2006. He was one of only five Texans named to the list, and we are proud to see his expertise and results acknowledged nationally. Under his leadership, we have expanded Wealth Management Services to include offices in Houston and Dallas, so that we can better offer high-level, integrated financial, investment, tax and estate planning advice to our highest-net-worth clients statewide.

Our insurance operations have rebounded, providing $29.5 million in revenue. We have worked hard to consolidate the independent insurance agencies we purchased over the past eight years in our key markets into one cohesive group. Frost Insurance, which ranks 34th in insurance revenues among U.S. bank holding companies, continues to focus on refining the organization and structure so that we can operate efficiently as one agency.

As anyone who spends any time driving around in any city in Texas knows, the competitive landscape in this state continues to be challenging. The fact is, in spite of extraordinary growth in the number of bank locations in Texas, population growth is also very strong, and I believe we will continue to see new banks coming into the state and opening additional branches. They understand what we have known for more than 139 years—that this is a great place to do business. I wouldn't want to be anywhere else. Competition doesn't frighten me. It just reinforces my confidence that this company can compete effectively.

I am often asked how we can compete with large coast-to-coast banking organizations in all of our markets. The answer is multifaceted. We do it by growing and by remaining profitable. We do it by being where we are —in the key growth markets of the state. We do it by offering a broad diversity in business lines, products and services that our customers need. We do it by having the right people in place to get the job done, along with the right processes and the right disciplines to enable them to effectively assign responsibilities, measure results and achieve our goals. We do it by executing our strategies every day. And most of all, we do it by living our values as a relationship bank.

Our staff rose to new levels of performance on so many occasions this year, and I am extremely proud of their commitment to our company, their solutions-oriented approach and their can-do attitude no matter what the challenge. They understand, as I do, that one of our primary goals is to build value every day. In everything we do, our employees are the foundation of our success, and I thank them.

I am grateful to our directors, who provide me with independent counsel and invaluable insights throughout the year. And I thank you, our shareholders, for your continued loyalty and support and your belief in this company. We always work hard to maintain your trust and to build and sustain shareholder value.

SINCERELY,

DICK EVANS

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

The Board of Directors

of Cullen/Frost Bankers, Inc. and The Frost National Bank

R. Denny Alexander
Owner
R. Denny Alexander & Company

Carlos Alvarez
Chairman, President and CEO
The Gambrinus Company

Royce S. Caldwell[1,2]
Retired
AT&T Inc.

Crawford H. Edwards
President
Cassco Land Company

Ruben M. Escobedo[3]
Certified Public Accountant

Dick Evans[4]
Chairman and Chief Executive Officer
Cullen/Frost Bankers, Inc.

Pat Frost
President
Frost National Bank

Tom Frost
Senior Chairman
Cullen/Frost Bankers, Inc.

Karen E. Jennings
Senior Executive Vice President
Advertising and Corporate Communications
AT&T Inc.

Richard M. Kleberg, III
Investments

Robert S. McClane
President
McClane Partners, LLC

Ida Clement Steen[5]
Investments

Horace Wilkins, Jr.[6]
Retired
AT&T Inc.

Senior Officers

Tom Frost
Senior Chairman

Dick Evans
Chairman and
Chief Executive Officer

Dave Beck
President
Chief Business Banking Officer

Bobby Berman
Group Executive Vice President
E-Commerce Operations, Data Warehouse,
Research and Strategy

Paul Bracher
President
State Regions

Pat Frost
President
Frost National Bank

Phillip D. Green
Group Executive Vice President
and Chief Financial Officer

Richard Kardys
Group Executive Vice President
Financial Management Group

Stan McCormick
Executive Vice President
Corporate Counsel and
Corporate Secretary

Paul Olivier
Group Executive Vice President
and Chief Consumer Banking Officer

Bill Perotti
Group Executive Vice President
Chief Credit Officer
and Chief Risk Officer

Emily Skillman
Group Executive Vice President
Human Resources

1. Chair, Compensation & Benefits Committee — 2. Chair, Corporate Governance & Nominating Committee — 3. Chair, Audit Committee
4. Chair, Strategic Planning Committee — 5. Chair, Trust Committee (Frost Bank) — 6. Chair, Directors Loan/CRA Committee (Frost Bank)

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

☑ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended: December 31, 2006

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ________ to ________

Commission file number: 0-7275

CULLEN/FROST BANKERS, INC.

(Exact name of registrant as specified in its charter)

Texas	**74-1751768**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 W. Houston Street, San Antonio, Texas	**78205**
(Address of principal executive offices)	(Zip code)

(210) 220-4011
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $.01 Par Value, and attached Stock Purchase Rights	**The New York Stock Exchange, Inc.**
(Title of each class)	(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☑ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☑

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☑ Accelerated filer ☐ Non-accelerated filer ☐

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

As of June 30, 2006, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the shares of common stock held by non-affiliates, based upon the closing price per share of the registrant's common stock as reported on The New York Stock Exchange, Inc., was approximately $3.0 billion.

As of January 26, 2007, there were 59,862,627 shares of the registrant's common stock, $.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2007 Annual Meeting of Shareholders of Cullen/Frost Bankers, Inc. to be held on April 26, 2007 are incorporated by reference in this Form 10-K in response to Part III, Items 10, 11, 12, 13 and 14.

CULLEN/FROST BANKERS, INC.
ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS

PART I

ITEM 1. BUSINESS

The disclosures set forth in this item are qualified by Item 1A. Risk Factors and the section captioned "Forward-Looking Statements and Factors that Could Affect Future Results" in Item 7. 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.

The Corporation

Cullen/Frost Bankers, Inc. ("Cullen/Frost"), a Texas business corporation incorporated in 1977, is a financial holding company and a bank holding company headquartered in San Antonio, Texas that provides, through its subsidiaries (collectively referred to as the "Corporation"), a broad array of products and services throughout numerous Texas markets. The Corporation offers commercial and consumer banking services, as well as trust and investment management, investment banking, insurance brokerage, leasing, asset-based lending, treasury management and item processing services. At December 31, 2006, Cullen/Frost had consolidated total assets of $13.2 billion and was one of the largest independent bank holding companies headquartered in the State of Texas.

The Corporation's philosophy is to grow and prosper, building long-term relationships based on top quality service, high ethical standards, and safe, sound assets. The Corporation operates as a locally oriented, community-based financial services organization, augmented by experienced, centralized support in select critical areas. The Corporation's local market orientation is reflected in its regional management and regional advisory boards, which are comprised of local business persons, professionals and other community representatives, that assist the Corporation's regional management in responding to local banking needs. Despite this local market, community-based focus, the Corporation offers many of the products available at much larger money-center financial institutions.

The Corporation serves a wide variety of industries including, among others, energy, manufacturing, services, construction, retail, telecommunications, healthcare, military and transportation. The Corporation's customer base is similarly diverse. The Corporation is not dependent upon any single industry or customer.

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. During 2006, the Corporation acquired Texas Community Bancshares, Inc. (Dallas market area), Alamo Corporation of Texas (Rio Grande Valley market area) and Summit Bancshares, Inc. (Ft. Worth market area). During 2005, the Corporation acquired Horizon Capital Bank (Houston market area). Details of these transactions are presented in Note 2 — Mergers and Acquisitions in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which is located elsewhere in this report.

Although Cullen/Frost is a corporate entity, legally separate and distinct from its affiliates, bank holding companies such as Cullen/Frost are generally required to act as a source of financial strength for their subsidiary banks. The principal source of Cullen/Frost's income is dividends from its subsidiaries. There are certain regulatory restrictions on the extent to which these subsidiaries can pay dividends or otherwise supply funds to Cullen/Frost. See the section captioned "Supervision and Regulation" for further discussion of these matters.

Cullen/Frost's executive offices are located at 100 W. Houston Street, San Antonio, Texas 78205, and its telephone number is (210) 220-4011.

Subsidiaries of Cullen/Frost

The New Galveston Company

Incorporated under the laws of Delaware, The New Galveston Company is a wholly owned second-tier financial holding company and bank holding company, which directly owns all of Cullen/Frost's banking and non-banking subsidiaries with the exception of Cullen/Frost Capital Trust I, Cullen/Frost Capital Trust II, Alamo Corporation of Texas Trust I and Summit Bancshares Statutory Trust I.

Cullen/Frost Capital Trust I, Cullen/Frost Capital Trust II, Alamo Corporation of Texas Trust I and Summit Bancshares Statutory Trust I

Cullen/Frost Capital Trust I ("Trust I") and Cullen/Frost Capital Trust II ("Trust II") are Delaware statutory business trusts formed in 1997 and 2004, respectively, for the purpose of issuing $100.0 million and $120.0 million, respectively, in trust preferred securities and lending the proceeds to Cullen/Frost. Alamo Corporation of Texas Trust I ("Alamo Trust") is a Delaware statutory trust formed in 2002 for the purpose of issuing $3.0 million in trust preferred securities. Alamo Trust was acquired by Cullen/Frost through the acquisition of Alamo Corporation of Texas on February 28, 2006. Summit Bancshares Statutory Trust I ("Summit Trust") is a Delaware statutory trust formed in 2004 for the purpose of issuing $12.0 million in trust preferred securities. Summit Trust was acquired by Cullen/Frost through the acquisition of Summit Bancshares on December 8, 2006. Cullen/Frost guarantees, on a limited basis, payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities.

Trust I, Trust II, Alamo Trust and Summit Trust (collectively referred to as the "Capital Trusts") are variable interest entities (VIEs) for which the Corporation is not the primary beneficiary, as defined in Financial Accounting Standards Board Interpretation ("FIN") No. 46 "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51 (Revised December 2003)." In accordance with FIN 46R, which was implemented in the fourth quarter of 2003, the accounts of the Capital Trusts are not included in the Corporation's consolidated financial statements. Prior to the fourth quarter of 2003, the financial statements of Trust I were included in the consolidated financial statements of the Corporation because Cullen/Frost owns all of the outstanding common equity securities of the Trust. See the Corporation's accounting policy related to consolidation in Note 1 — Summary of Significant Accounting Policies in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which is located elsewhere in this report.

Despite the fact that the accounts of the Capital Trusts are not included in the Corporation's consolidated financial statements, the $235.0 million in trust preferred securities issued by these subsidiary trusts are included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes as allowed by the Federal Reserve Board. In February 2005, the Federal Reserve Board issued a final rule that allows the continued inclusion of trust preferred securities in the Tier 1 capital of bank holding companies. The Board's final rule limits the aggregate amount of restricted core capital elements (which includes trust preferred securities, among other things) that may be included in the Tier 1 capital of most bank holding companies to 25% of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Large, internationally active bank holding companies (as defined) are subject to a 15% limitation. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The final rule provides a five-year transition period, ending March 31, 2009, for application of the quantitative limits. The Corporation does not expect that the quantitative limits will preclude it from including the $235.0 million in trust preferred securities in Tier 1 capital. However, the trust preferred securities could be redeemed without penalty if they were no longer permitted to be included in Tier 1 capital. The Corporation expects to redeem the $100 million in trust preferred securities issued by Trust I during the first quarter of 2007. As a result of the anticipated redemption, the Corporation expects to incur approximately $5.3 million in expense related to the prepayment penalty and the write-off of unamortized debt issuance costs. See Note 9 — Borrowed Funds and Note 12 — Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which is located elsewhere in this report.

The Frost National Bank

The Frost National Bank ("Frost Bank") is primarily engaged in the business of commercial and consumer banking through more than 100 financial centers across Texas in the Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio regions. Frost Bank was chartered as a national banking association in 1899, but its origin can be traced to a mercantile partnership organized in 1868. At December 31, 2006, Frost Bank had consolidated total assets of $13.2 billion and total deposits of $10.5 billion and was one of the largest commercial banks headquartered in the State of Texas.

Significant services offered by Frost Bank include:

- *Commercial Banking.* Frost Bank provides commercial banking services to corporations and other business clients. Loans are made for a wide variety of general corporate purposes, including financing for industrial and commercial properties and to a lesser extent, financing for interim construction related to industrial and commercial properties, financing for equipment, inventories and accounts receivable, and acquisition financing, as well as commercial leasing and treasury management services.

- *Consumer Services.* Frost Bank provides a full range of consumer banking services, including checking accounts, savings programs, automated teller machines, overdraft facilities, installment and real estate loans, home equity loans and lines of credit, drive-in and night deposit services, safe deposit facilities, and brokerage services.

- *International Banking.* Frost Bank provides international banking services to customers residing in or dealing with businesses located in Mexico. These services consist of accepting deposits (generally only in U.S. dollars), making loans (in U.S. dollars only), issuing letters of credit, handling foreign collections, transmitting funds, and to a limited extent, dealing in foreign exchange.

- *Correspondent Banking.* Frost Bank acts as correspondent for approximately 283 financial institutions, which are primarily banks in Texas. These banks maintain deposits with Frost Bank, which offers them a full range of services including check clearing, transfer of funds, fixed income security services, and securities custody and clearance services.

- *Trust Services.* Frost Bank provides a wide range of trust, investment, agency and custodial services for individual and corporate clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans and charitable foundations. At December 31, 2006, the estimated fair value of trust assets was $23.2 billion, including managed assets of $9.3 billion and custody assets of $13.9 billion.

- *Capital Markets — Fixed-Income Services.* Frost Bank's Capital Markets Division was formed to meet the transaction needs of fixed-income institutional investors. Services include sales and trading, new issue underwriting, money market trading, and securities safekeeping and clearance.

Frost Insurance Agency, Inc.

Frost Insurance Agency, Inc. is a wholly owned subsidiary of Frost Bank that provides insurance brokerage services to individuals and businesses covering corporate and personal property and casualty insurance products, as well as group health and life insurance products.

Frost Brokerage Services, Inc.

Frost Brokerage Services, Inc. ("FBS") is a wholly owned subsidiary of Frost Bank that provides brokerage services and performs other transactions or operations related to the sale and purchase of securities of all types. FBS is registered as a fully disclosed introducing broker-dealer under the Securities Exchange Act of 1934 and, as such, does not hold any customer accounts.

Frost Premium Finance Corporation

Frost Premium Finance Corporation is a wholly owned subsidiary of Frost Bank that makes loans to qualified borrowers for the purpose of financing their purchase of property and casualty insurance.

Frost Securities, Inc.

Frost Securities, Inc. is a wholly owned subsidiary that provides advisory and private equity services to middle market companies in Texas.

Main Plaza Corporation

Main Plaza Corporation is a wholly owned non-banking subsidiary that occasionally makes loans to qualified borrowers. Loans are funded with current cash or borrowings against internal credit lines.

Daltex General Agency, Inc.

Daltex General Agency, Inc. is a wholly owned non-banking subsidiary that operates as a managing general insurance agency providing insurance on certain auto loans financed by Frost Bank.

Other Subsidiaries

Cullen/Frost has various other subsidiaries that are not significant to the consolidated entity.

Operating Segments

Cullen/Frost's operations are managed along two reportable operating segments consisting of Banking and the Financial Management Group. See the sections captioned "Results of Segment Operations" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 19 — Operating Segments in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

Competition

There is significant competition among commercial banks in the Corporation's market areas. As a result of the deregulation of the financial services industry (see the discussion of the Gramm-Leach-Bliley Financial Modernization Act of 1999 in the section of this item captioned "Supervision and Regulation"), the Corporation also competes with other providers of financial services, such as savings and loan associations, credit unions, consumer finance companies, securities firms, insurance companies, insurance agencies, commercial finance and leasing companies, full service brokerage firms and discount brokerage firms. Some of the Corporation's competitors have greater resources and, as such, may have higher lending limits and may offer other services that are not provided by the Corporation. The Corporation generally competes on the basis of customer service and responsiveness to customer needs, available loan and deposit products, the rates of interest charged on loans, the rates of interest paid for funds, and the availability and pricing of trust, brokerage and insurance services.

Supervision and Regulation

Cullen/Frost, Frost Bank and many of its non-banking subsidiaries are subject to extensive regulation under federal and state laws. The regulatory framework is intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole and not for the protection of security holders.

Set forth below is a description of the significant elements of the laws and regulations applicable to Cullen/Frost and its subsidiaries. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to Cullen/Frost and its subsidiaries could have a material effect on the business of the Corporation.

Regulatory Agencies

Cullen/Frost is a legal entity separate and distinct from Frost Bank and its other subsidiaries. As a financial holding company and a bank holding company, Cullen/Frost is regulated under the Bank Holding Company Act of 1956, as amended ("BHC Act"), and is subject to inspection, examination and supervision by the Board of Governors of the Federal Reserve System ("Federal Reserve Board"). Cullen/Frost is also under the jurisdiction of the Securities and Exchange Commission ("SEC") and is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC. Cullen/Frost is listed on the New York Stock Exchange ("NYSE") under the trading symbol "CFR," and is subject to the rules of the NYSE for listed companies.

Frost Bank is organized as a national banking association under the National Bank Act. It is subject to regulation and examination by the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC").

Many of the Corporation's non-bank subsidiaries also are subject to regulation by the Federal Reserve Board and other federal and state agencies. Frost Securities, Inc. and Frost Brokerage Services, Inc. are regulated by the SEC, the National Association of Securities Dealers, Inc. ("NASD") and state securities regulators. The Corporation's insurance subsidiaries are subject to regulation by applicable state insurance regulatory agencies. Other non-bank subsidiaries are subject to both federal and state laws and regulations.

Bank Holding Company Activities

In general, the BHC Act limits the business of bank holding companies to banking, managing or controlling banks and other activities that the Federal Reserve Board has determined to be so closely related to banking as to be a proper incident thereto. As a result of the Gramm-Leach-Bliley Financial Modernization Act of 1999 ("GLB Act"), which amended the BHC Act, bank holding companies that are financial holding companies may engage in any activity, or acquire and retain the shares of a company engaged in any activity that is either (i) financial in nature or incidental to such financial activity (as determined by the Federal Reserve Board in consultation with the OCC) or (ii) complementary to a financial activity, and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally (as solely determined by the Federal Reserve Board). Activities that are financial in nature include securities underwriting and dealing, insurance underwriting and making merchant banking investments.

If a bank holding company seeks to engage in the broader range of activities that are permitted under the BHC Act for financial holding companies, (i) all of its depository institution subsidiaries must be "well capitalized" and "well managed" and (ii) it must file a declaration with the Federal Reserve Board that it elects to be a "financial holding company." A depository institution subsidiary is considered to be "well capitalized" if it satisfies the requirements for this status discussed in the section captioned "Capital Adequacy and Prompt Corrective Action," included elsewhere in this item. A depository institution subsidiary is considered "well managed" if it received a composite rating and management rating of at least "satisfactory" in its most recent examination. Cullen/Frost's declaration to become a financial holding company was declared effective by the Federal Reserve Board on March 11, 2000.

In order for a financial holding company to commence any new activity permitted by the BHC Act, or to acquire a company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least "satisfactory" in its most recent examination under the Community Reinvestment Act. See the section captioned "Community Reinvestment Act" included elsewhere in this item.

The BHC Act generally limits acquisitions by bank holding companies that are not qualified as financial holding companies to commercial banks and companies engaged in activities that the Federal Reserve Board has determined to be so closely related to banking as to be a proper incident thereto. Financial holding companies like Cullen/Frost are also permitted to acquire companies engaged in activities that are financial in nature and in activities that are incidental and complementary to financial activities without prior Federal Reserve Board approval.

The BHC Act, the Federal Bank Merger Act, the Texas Banking Code and other federal and state statutes regulate acquisitions of commercial banks. The BHC Act requires the prior approval of the Federal Reserve Board for the direct or indirect acquisition of more than 5.0% of the voting shares of a commercial bank or its parent holding company. Under the Federal Bank Merger Act, the prior approval of the OCC is required for a national bank to merge with another bank or purchase the assets or assume the deposits of another bank. In reviewing applications seeking approval of merger and acquisition transactions, the bank regulatory authorities will consider, among other things, the competitive effect and public benefits of the transactions, the capital position of the combined organization, the applicant's performance record under the Community Reinvestment Act (see the section captioned "Community Reinvestment Act" included elsewhere in this item) and fair housing laws and the effectiveness of the subject organizations in combating money laundering activities.

Dividends

The principal source of Cullen/Frost's cash revenues is dividends from Frost Bank. The prior approval of the OCC is required if the total of all dividends declared by a national bank in any calendar year would exceed the sum of the bank's net profits for that year and its retained net profits for the preceding two calendar years, less any required transfers to surplus. Federal law also prohibits national banks from paying dividends that would be greater than the bank's undivided profits after deducting statutory bad debt in excess of the bank's allowance for loan losses. Under the foregoing dividend restrictions, and without adversely affecting its "well capitalized" status, Frost Bank could pay aggregate dividends of approximately $180.6 million to Cullen/Frost, without obtaining affirmative governmental approvals, at December 31, 2006. This amount is not necessarily indicative of amounts that may be paid or available to be paid in future periods.

In addition, Cullen/Frost and Frost Bank are subject to other regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The appropriate federal regulatory authority is authorized to determine under certain circumstances relating to the financial condition of a bank holding company or a bank that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The appropriate federal regulatory authorities have indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice and that banking organizations should generally pay dividends only out of current operating earnings.

Borrowings

There are various restrictions on the ability of Cullen/Frost and its non-bank subsidiaries to borrow from, and engage in certain other transactions with, Frost Bank. In general, these restrictions require that any extensions of credit must be secured by designated amounts of specified collateral and are limited, as to any one of Cullen/Frost or its non-bank subsidiaries, to 10% of Frost Bank's capital stock and surplus, and, as to Cullen/Frost and all such non-bank subsidiaries in the aggregate, to 20% of Frost Bank's capital stock and surplus.

Federal law also provides that extensions of credit and other transactions between Frost Bank and Cullen/Frost or one of its non-bank subsidiaries must be on terms and conditions, including credit standards, that are substantially the same or at least as favorable to Frost Bank as those prevailing at the time for comparable transactions involving other non-affiliated companies or, in the absence of comparable transactions, on terms and conditions, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.

Source of Strength Doctrine

Federal Reserve Board policy requires bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this policy, Cullen/Frost is expected to commit resources to support Frost Bank, including at times when Cullen/Frost may not be in a financial position to provide it. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary banks. The BHC Act provides that, in the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

In addition, under the National Bank Act, if the capital stock of Frost Bank is impaired by losses or otherwise, the OCC is authorized to require payment of the deficiency by assessment upon Cullen/Frost. If the assessment is not paid within three months, the OCC could order a sale of the Frost Bank stock held by Cullen/Frost to make good the deficiency.

Capital Adequacy and Prompt Corrective Action

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.

The Federal Reserve Board, the OCC and the FDIC have substantially similar risk-based capital ratio and leverage ratio guidelines for banking organizations. The guidelines are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off-balance sheet financial instruments. Under the guidelines, banking organizations are required to maintain minimum ratios for Tier 1 capital and total capital to risk-weighted assets (including certain off-balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization's assets and some of its specified off-balance sheet commitments and obligations are assigned to various risk categories. A depository institution's or holding company's capital, in turn, is classified in one of three tiers, depending on type:

- *Core Capital (Tier 1).* Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual stock at the holding company level, minority interests in equity accounts of consolidated subsidiaries, qualifying trust preferred securities, less goodwill, most intangible assets and certain other assets.

- *Supplementary Capital (Tier 2).* Tier 2 capital includes, among other things, perpetual preferred stock and trust preferred securities not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for possible loan and lease losses, subject to limitations.

- *Market Risk Capital (Tier 3).* Tier 3 capital includes qualifying unsecured subordinated debt.

Cullen/Frost, like other bank holding companies, currently is required to maintain Tier 1 capital and "total capital" (the sum of Tier 1, Tier 2 and Tier 3 capital) equal to at least 4.0% and 8.0%, respectively, of its total risk-weighted assets (including various off-balance-sheet items, such as letters of credit). Frost Bank, like other depository institutions, is required to maintain similar capital levels under capital adequacy guidelines. For a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its Tier 1 and total capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively.

Bank holding companies and banks subject to the market risk capital guidelines are required to incorporate market and interest rate risk components into their risk-based capital standards. Under the market risk capital guidelines, capital is allocated to support the amount of market risk related to a financial institution's ongoing trading activities.

Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The requirements necessitate a minimum leverage ratio of 3.0% for financial holding companies and national banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk. All other financial holding companies and national banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. For a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%. The Federal Reserve Board has not advised Cullen/Frost, and the OCC has not advised Frost Bank, of any specific minimum leverage ratio applicable to it.

The Federal Deposit Insurance Act, as amended ("FDIA"), requires among other things, the federal banking agencies to take "prompt corrective action" in respect of depository institutions that do not meet minimum capital requirements. The FDIA sets forth the following five capital tiers: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." A depository institution's capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total capital ratio, the Tier 1 capital ratio and the leverage ratio.

Under the regulations adopted by the federal regulatory authorities, a bank will be: (i) "well capitalized" if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure; (ii) "adequately capitalized" if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater and is not "well capitalized"; (iii) "undercapitalized" if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 4.0%; (iv) "significantly undercapitalized" if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0% or a leverage ratio of less than 3.0%; and (v) "critically undercapitalized" if the institution's tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. Cullen/Frost believes that, as of December 31, 2006, its bank subsidiary, Frost Bank, was "well capitalized," based on the ratios and guidelines described above. A bank's capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank's overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be "undercapitalized." "Undercapitalized" institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. In addition, for a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution's total assets at the time it became undercapitalized or (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is "significantly undercapitalized."

"Significantly undercapitalized" depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become "adequately capitalized," requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. "Critically undercapitalized" institutions are subject to the appointment of a receiver or conservator.

For information regarding the capital ratios and leverage ratio of Cullen/Frost and Frost Bank see the discussion under the section captioned "Capital and Liquidity" included in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 12 — Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, elsewhere in this report.

The federal regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord of the Basel Committee on Banking Supervision (the "BIS"). The BIS is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies they apply. In 2004, the BIS published a new capital accord to replace its 1988 capital accord, with an update in November 2005 ("BIS II"). BIS II provides two approaches for setting capital standards for credit risk — an internal ratings-based approach tailored to individual institutions' circumstances (which for many asset classes is itself broken into a "foundation" approach and an "advanced or A-IRB" approach, the availability of which is subject to additional restrictions) and a standardized approach that bases risk weightings on external credit assessments to a much greater extent than permitted in existing risk-based capital guidelines. BIS II also would set capital requirements for operational risk and refine the existing capital requirements for market risk exposures.

The U.S. banking and thrift agencies are developing proposed revisions to their existing capital adequacy regulations and standards based on BIS II. In September 2006, the agencies issued a notice of proposed rulemaking setting forth a definitive proposal for implementing BIS II in the United States that would apply only to internationally active banking organizations — defined as those with consolidated total assets of $250 billion or more or consolidated on-balance sheet foreign exposures of $10 billion or more — but that other U.S. banking organizations could elect but would not be required to apply. In December 2006, the agencies issued a notice of proposed rulemaking describing proposed amendments to their existing risk-based capital guidelines to make them more risk-sensitive, generally following aspects of the standardized approach of BIS II. These latter proposed amendments, often referred to as "BIS I-A", would apply to banking organizations that are not internationally active banking organizations subject to the A-IRB approach for internationally active banking organizations and do not "opt in" to that approach. The agencies previously had issued advance notices of proposed rulemaking on both proposals (in August 2003 regarding the A-IRB approach of BIS II for internationally active banking organizations and in October 2005 regarding BIS II).

The comment periods for both of the agencies' notices of proposed rulemakings expire on March 26, 2007. The agencies have indicated their intent to have the A-IRB provisions for internationally active U.S. banking organizations first become effective in March 2009 and that those provisions and the BIS I-A provisions for others will be implemented on similar timeframes.

The Corporation is not an internationally active banking organization and has not made a determination as to whether it would opt to apply the A-IRB provisions applicable to internationally active U.S. banking organizations once they become effective.

Deposit Insurance

Substantially all of the deposits of Frost Bank are insured up to applicable limits by the Deposit Insurance Fund ("DIF") of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank's capital level and supervisory rating. Frost Bank was not required to pay any deposit insurance premiums in 2006; however, it is possible that the FDIC could impose assessment rates in the future in connection with declines in the insurance funds or increases in the amount of insurance coverage. An increase in the assessment rate could have a material adverse effect on the Corporation's earnings, depending on the amount of the increase. Under the Federal Deposit Insurance Reform Act of 2005, which became law in 2006, Frost Bank received a one-time assessment credit of $8.2 million that can be applied against future premiums, subject to certain limitations. During 2006, Frost Bank paid $1.2 million in Financing Corporation ("FICO") assessments related to outstanding FICO bonds to the FDIC as collection agent. The FICO is a mixed-ownership government corporation established by the Competitive Equality Banking Act of 1987 whose sole purpose was to function as a financing vehicle for the now defunct Federal Savings & Loan Insurance Corporation.

Depositor Preference

The FDIA provides that, in the event of the "liquidation or other resolution" of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

Liability of Commonly Controlled Institutions

FDIC-insured depository institutions can be held liable for any loss incurred, or reasonably expected to be incurred, by the FDIC due to the default of an FDIC-insured depository institution controlled by the same bank holding company, or for any assistance provided by the FDIC to an FDIC-insured depository institution controlled by the same bank holding company that is in danger of default. "Default" means generally the appointment of a conservator or receiver. "In danger of default" means generally the existence of certain conditions indicating that default is likely to occur in the absence of regulatory assistance.

Community Reinvestment Act

The Community Reinvestment Act of 1977 ("CRA") requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low- and moderate-income individuals and communities. Depository institutions are periodically examined for compliance with the CRA and are assigned ratings. In order for a financial holding company to commence any new activity permitted by the BHC Act, or to acquire any company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least "satisfactory" in its most recent examination under the CRA. Furthermore, banking regulators take into account CRA ratings when considering approval of a proposed transaction.

Financial Privacy

In accordance with the GLB Act, federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. The privacy provisions of the GLB Act affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

Anti-Money Laundering and the USA Patriot Act

A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001 (the "USA Patriot Act") substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. The United States Treasury Department has issued and, in some cases, proposed a number of regulations that apply various requirements of the USA Patriot Act to financial institutions such as Cullen/Frost's bank and broker-dealer subsidiaries. These regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers. Certain of those regulations impose specific due diligence requirements on financial institutions that maintain correspondent or private banking relationships with non-U.S. financial institutions or persons. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution.

Office of Foreign Assets Control Regulation

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the "OFAC" rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control ("OFAC"). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences.

Legislative Initiatives

From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Corporation in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Corporation cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Corporation. A change in statutes, regulations or regulatory policies applicable to Cullen/Frost or any of its subsidiaries could have a material effect on the business of the Corporation.

Employees

At December 31, 2006, the Corporation employed 3,652 full-time equivalent employees. None of the Corporation's employees are represented by collective bargaining agreements. The Corporation believes its employee relations to be good.

Executive Officers of the Registrant

The names, ages as of December 31, 2006, recent business experience and positions or offices held by each of the executive officers of Cullen/Frost are as follows:

Name and Position Held	Age	Recent Business Experience
T.C. Frost Senior Chairman of the Board and Director	79	Officer and Director of Frost Bank since 1950. Chairman of the Board of Cullen/Frost from 1973 to October 1995. Chief Executive Officer of Cullen/Frost from July 1977 to October 1997. Senior Chairman of Cullen/Frost from October 1995 to present.
Richard W. Evans, Jr. Chairman of the Board, Chief Executive Officer and Director	60	Officer of Frost Bank since 1973. Chairman of the Board and Chief Executive Officer of Cullen/Frost from October 1997 to present.
Patrick B. Frost President of Frost Bank and Director	46	Officer of Frost Bank since 1985. President of Frost Bank from August 1993 to present. Director of Cullen/Frost from May 1997 to present.
Phillip D. Green Group Executive Vice President, Chief Financial Officer	52	Officer of Frost Bank since July 1980. Group Executive Vice President, Chief Financial Officer of Cullen/Frost from October 1995 to present.
David W. Beck President, Chief Business Banking Officer of Frost Bank	56	Officer of Frost Bank since July 1973. President, Chief Business Banking Officer of Frost Bank from February 2001 to present.
Robert A. Berman Group Executive Vice President, Internet Financial Services of Frost Bank	44	Office of Frost Bank since January 1989. Group Executive Vice President, Internet Financial Services of Frost Bank from May 2001 to present.

Name and Position Held	Age	Recent Business Experience
Paul H. Bracher President, State Regions of Frost Bank	50	Officer of Frost Bank since January 1982. President, State Regions of Frost Bank from February 2001 to present.
Richard Kardys Group Executive Vice President, Executive Trust Officer of Frost Bank	60	Officer of Frost Bank since January 1977. Group Executive Vice President, Executive Trust Officer of Frost Bank from May 2001 to present.
Paul J. Olivier Group Executive Vice President, Consumer Banking of Frost Bank	54	Officer of Frost Bank since August 1976. Group Executive Vice President, Consumer Banking of Frost Bank from May 2001 to present.
William L. Perotti Group Executive Vice President, Chief Credit Officer and Chief Risk Officer of Frost Bank	49	Officer of Frost Bank since December 1982. Group Executive Vice President, Chief Credit Officer of Frost Bank from May 2001 to present. Chief Risk Officer of Frost Bank from April 2005 to present.
Emily A. Skillman Group Executive Vice President, Human Resources of Frost Bank	62	Officer of Frost Bank since January 1998. Senior Vice President, Human Resources of Frost Bank from July 2000 to October 2003. Group Executive Vice President, Human Resources of Frost Bank from October 2003 to present.

There are no arrangements or understandings between any executive officer of Cullen/Frost and any other person pursuant to which such executive officer was or is to be selected as an officer.

Available Information

Under the Securities Exchange Act of 1934, Cullen/Frost is required to file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission ("SEC"). You may read and copy any document Cullen/Frost files with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information about the public reference room. The SEC maintains a website at http://www.sec.gov that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. Cullen/Frost files electronically with the SEC.

Cullen/Frost makes available, free of charge through its website, its reports on Forms 10-K, 10-Q and 8-K, and amendments to those reports, as soon as reasonably practicable after such reports are filed with or furnished to the SEC. Additionally, the Corporation has adopted and posted on its website a code of ethics that applies to its principal executive officer, principal financial officer and principal accounting officer. The Corporation's website also includes its corporate governance guidelines and the charters for its audit committee, its compensation and benefits committee, and its corporate governance and nominating committee. The address for the Corporation's website is http://www.frostbank.com. The Corporation will provide a printed copy of any of the aforementioned documents to any requesting shareholder.

ITEM 1A. RISK FACTORS

An investment in the Corporation's common stock is subject to risks inherent to the Corporation's business. The material risks and uncertainties that management believes affect the Corporation are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing the Corporation. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Corporation's business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, the Corporation's financial condition and results of operations could be materially and adversely affected. If this were to happen, the market price of the Corporation's common stock could decline significantly, and you could lose all or part of your investment.

Risks Related To The Corporation's Business

The Corporation Is Subject To Interest Rate Risk

The Corporation's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Corporation's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Corporation receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Corporation's ability to originate loans and obtain deposits, (ii) the fair value of the Corporation's financial assets and liabilities, and (iii) the average duration of the Corporation's mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Corporation's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies, including the use of derivatives as hedging instruments, to reduce the potential effects of changes in interest rates on the Corporation's results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Corporation's financial condition and results of operations. See the section captioned "Net Interest Income" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation's management of interest rate risk.

The Corporation Is Subject To Lending Risk

There are inherent risks associated with the Corporation's lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where the Corporation operates as well as those across the State of Texas and the United States. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. The Corporation is also subject to various laws and regulations that affect its lending activities. Failure to comply with applicable laws and regulations could subject the Corporation to regulatory enforcement action that could result in the assessment of significant civil money penalties against the Corporation.

As of December 31, 2006, approximately 81% of the Corporation's loan portfolio consisted of commercial and industrial, construction and commercial real estate mortgage loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Corporation's loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation's financial condition and results of operations. See the section captioned "Loans" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to commercial and industrial, construction and commercial real estate loans.

The Corporation's Allowance For Possible Loan Losses May Be Insufficient

The Corporation maintains an allowance for possible loan losses, which is a reserve established through a provision for possible loan losses charged to expense, that 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. The determination of the appropriate level of the allowance for possible loan losses inherently involves a high degree of subjectivity and requires the Corporation to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of the Corporation's control, may require an increase in the allowance for possible loan losses. In addition, bank regulatory agencies periodically review the Corporation's allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for possible loan losses, the Corporation will need additional provisions to increase the allowance for possible loan losses. Any increases in the allowance for possible loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on the Corporation's financial condition and results of operations. See the section captioned "Allowance for Possible Loan Losses" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation's process for determining the appropriate level of the allowance for possible loan losses.

The Corporation Is Subject To Environmental Liability Risk Associated With Lending Activities

A significant portion of the Corporation's loan portfolio is secured by real property. During the ordinary course of business, the Corporation may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Corporation may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Corporation to incur substantial expenses and may materially reduce the affected property's value or limit the Corporation's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Corporation's exposure to environmental liability. Although the Corporation has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation's Profitability Depends Significantly On Economic Conditions In The State Of Texas

The Corporation's success depends primarily on the general economic conditions of the State of Texas and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers across Texas through financial centers in the Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio regions. The local economic conditions in these areas have a significant impact on the demand for the Corporation's products and services as well as the ability of the Corporation's customers to repay loans, the value of the collateral securing loans and the stability of the Corporation's deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation Operates In A Highly Competitive Industry and Market Area

The Corporation faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets the Corporation operates. Additionally, various out-of-state banks have entered or have announced plans to enter the market areas in which the Corporation currently operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of the Corporation's competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than the Corporation can.

The Corporation's ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.
- The ability to expand the Corporation's market position.
- The scope, relevance and pricing of products and services offered to meet customer needs and demands.
- The rate at which the Corporation introduces new products and services relative to its competitors.
- Customer satisfaction with the Corporation's level of service.
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Corporation's competitive position, which could adversely affect the Corporation's growth and profitability, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation Is Subject To Extensive Government Regulation and Supervision

The Corporation, primarily through Cullen/Frost, Frost Bank and certain non-bank subsidiaries, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not security holders. These regulations affect the Corporation's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Corporation in substantial and unpredictable ways. Such changes could subject the Corporation to additional costs, limit the types of financial services and products the Corporation may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Corporation's business, financial condition and results of operations. While the Corporation has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned "Supervision and Regulation" in Item 1. Business and Note 12 — Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

The Corporation's Controls and Procedures May Fail or Be Circumvented

Management regularly reviews and updates the Corporation's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Corporation's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Corporation's business, results of operations and financial condition.

New Lines of Business or New Products and Services May Subject The Corporation to Additional Risks

From time to time, the Corporation may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services the Corporation may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Corporation's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Corporation's business, results of operations and financial condition.

Cullen/Frost Relies On Dividends From Its Subsidiaries For Most Of Its Revenue

Cullen/Frost is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on the Corporation's common stock and interest and principal on Cullen/Frost's debt. Various federal and/or state laws and regulations limit the amount of dividends that Frost Bank and certain non-bank subsidiaries may pay to Cullen/Frost. Also, Cullen/Frost's right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event Frost Bank is unable to pay dividends to Cullen/Frost, Cullen/Frost may not be able to service debt, pay obligations or pay dividends on the Corporation's common stock. The inability to receive dividends from Frost Bank could have a material adverse effect on the Corporation's business, financial condition and results of operations. See the section captioned "Supervision and Regulation" in Item 1. Business and Note 12 — Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

Potential Acquisitions May Disrupt the Corporation's Business and Dilute Stockholder Value

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 or expanded services. Acquiring other banks, businesses, or branches involves various risks commonly associated with acquisitions, including, among other things:

- Potential exposure to unknown or contingent liabilities of the target company.
- Exposure to potential asset quality issues of the target company.
- Difficulty and expense of integrating the operations and personnel of the target company.
- Potential disruption to the Corporation's business.
- Potential diversion of the Corporation's management's time and attention.
- The possible loss of key employees and customers of the target company.

- Difficulty in estimating the value of the target company.
- Potential changes in banking or tax laws or regulations that may affect the target company.

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 at any time. 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. Furthermore, failure to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from an acquisition could have a material adverse effect on the Corporation's financial condition and results of operations.

During 2006, the Corporation acquired Texas Community Bancshares, Inc. (Dallas market area), Alamo Corporation of Texas (Rio Grande Valley market area) and Summit Bancshares, Inc. (Fort Worth market area). During 2005, the Corporation acquired Horizon Capital Bank (Houston market area). Details of these transactions are presented in Note 2 — Mergers and Acquisitions in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which is located elsewhere in this report.

The Corporation May Not Be Able To Attract and Retain Skilled People

The Corporation's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Corporation can be intense and the Corporation may not be able to hire people or to retain them. The unexpected loss of services of one or more of the Corporation's key personnel could have a material adverse impact on the Corporation's business because of their skills, knowledge of the Corporation's market, years of industry experience and the difficulty of promptly finding qualified replacement personnel. The Corporation does not currently have employment agreements or non-competition agreements with any of its senior officers.

The Corporation's Information Systems May Experience An Interruption Or Breach In Security

The Corporation relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Corporation's customer relationship management, general ledger, deposit, loan and other systems. While the Corporation has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of the Corporation's information systems could damage the Corporation's reputation, result in a loss of customer business, subject the Corporation to additional regulatory scrutiny, or expose the Corporation to civil litigation and possible financial liability, any of which could have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation Continually Encounters Technological Change

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Corporation's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Corporation's operations. Many of the Corporation's competitors have substantially greater resources to invest in technological improvements. The Corporation may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Corporation's business and, in turn, the Corporation's financial condition and results of operations.

The Corporation Is Subject To Claims and Litigation Pertaining To Fiduciary Responsibility

From time to time, customers make claims and take legal action pertaining to the Corporation's performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Corporation's performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Corporation they may result in significant financial liability and/or adversely affect the market perception of the Corporation and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation's business, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

Severe Weather, Natural Disasters, Acts Of War Or Terrorism and Other External Events Could Significantly Impact The Corporation's Business

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Corporation's ability to conduct business. Such events could affect the stability of the Corporation's deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Corporation to incur additional expenses. Although management has established disaster recovery policies and procedures, the occurrence of any such event in the future could have a material adverse effect on the Corporation's business, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

Risks Associated With The Corporation's Common Stock

The Corporation's Stock Price Can Be Volatile

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. The Corporation's stock price can fluctuate significantly in response to a variety of factors including, among other things:

- Actual or anticipated variations in quarterly results of operations.
- Recommendations by securities analysts.
- Operating and stock price performance of other companies that investors deem comparable to the Corporation.
- News reports relating to trends, concerns and other issues in the financial services industry.
- Perceptions in the marketplace regarding the Corporation and/or its competitors.
- New technology used, or services offered, by competitors.
- Significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving the Corporation or its competitors.
- Failure to integrate acquisitions or realize anticipated benefits from acquisitions.
- Changes in government regulations.
- Geopolitical conditions such as acts or threats of terrorism or military conflicts.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause the Corporation's stock price to decrease regardless of operating results.

The Trading Volume In The Corporation's Common Stock Is Less Than That Of Other Larger Financial Services Companies

Although the Corporation's common stock is listed for trading on the New York Stock Exchange (NYSE), the trading volume in its common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation's common stock, significant sales of the Corporation's common stock, or the expectation of these sales, could cause the Corporation's stock price to fall.

An Investment In The Corporation's Common Stock Is Not An Insured Deposit

The Corporation's common stock is not a bank deposit and, therefore, is not insured against loss by the Federal Deposit Insurance Corporation (FDIC), any other deposit insurance fund or by any other public or private entity. Investment in the Corporation's common stock is inherently risky for the reasons described in this "Risk Factors" section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire the Corporation's common stock, you could lose some or all of your investment.

The Corporation's Articles Of Incorporation, By-Laws and Shareholders Rights Plan As Well As Certain Banking Laws May Have An Anti-Takeover Effect

Provisions of the Corporation's articles of incorporation and by-laws, federal banking laws, including regulatory approval requirements, and the Corporation's stock purchase rights plan could make it more difficult for a third party to acquire the Corporation, even if doing so would be perceived to be beneficial to the Corporation's shareholders. The combination of these provisions effectively inhibits a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Corporation's common stock.

Risks Associated With The Corporation's Industry

The Earnings Of Financial Services Companies Are Significantly Affected By General Business And Economic Conditions

The Corporation's operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U.S. economy and the local economies in which the Corporation operates, all of which are beyond the Corporation's control. A deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values and a decrease in demand for the Corporation's products and services, among other things, any of which could have a material adverse impact on the Corporation's financial condition and results of operations.

Financial Services Companies Depend On The Accuracy And Completeness Of Information About Customers And Counterparties

In deciding whether to extend credit or enter into other transactions, the Corporation may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. The Corporation may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on the Corporation's business and, in turn, the Corporation's financial condition and results of operations.

Consumers May Decide Not To Use Banks To Complete Their Financial Transactions

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on the Corporation's financial condition and results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

The Corporation's headquarters are located in downtown San Antonio, Texas. These facilities, which are owned by the Corporation, house the Corporation's executive and primary administrative offices, as well as the principal banking headquarters of Frost Bank. The Corporation also owns or leases other facilities within its primary market areas in the regions of Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio. The Corporation considers its properties to be suitable and adequate for its present needs.

ITEM 3. LEGAL PROCEEDINGS

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.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Common Stock Market Prices and Dividends

The Corporation's common stock is traded on the New York Stock Exchange, Inc. ("NYSE") under the symbol "CFR". The tables below set forth for each quarter of 2006 and 2005 the high and low intra-day sales prices per share of Cullen/Frost's common stock as reported by the NYSE and the cash dividends declared per share.

	2006		2005	
Sales Price Per Share	**High**	**Low**	**High**	**Low**
First quarter	$55.88	$52.34	$48.97	$43.87
Second quarter	58.49	52.04	47.99	41.90
Third quarter	59.55	54.48	50.60	47.07
Fourth quarter	58.67	53.09	56.43	47.33

Cash Dividends Per Share	**2006**	**2005**
First quarter	$0.30	$0.265
Second quarter	0.34	0.300
Third quarter	0.34	0.300
Fourth quarter	0.34	0.300
Total	$1.32	$1.165

As of December 31, 2006, there were 59,839,144 shares of the Corporation's common stock outstanding held by 1,991 holders of record. The closing price per share of common stock on December 29, 2006, the last trading day of the Corporation's fiscal year, was $55.82.

The Corporation's management is currently committed to continuing to pay regular cash dividends; however, there can be no assurance as to future dividends because they are dependent on the Corporation's future earnings, capital requirements and financial condition. See the section captioned "Supervision and Regulation" included in Item 1. Business, the section captioned "Capital and Liquidity" included in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 12 — Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, all of which are included elsewhere in this report.

Stock-Based Compensation Plans

Information regarding stock-based compensation awards outstanding and available for future grants as of December 31, 2006, segregated between stock-based compensation plans approved by shareholders and stock-based compensation plans not approved by shareholders, is presented in the table below. Additional information regarding stock-based compensation plans is presented in Note 13 — Employee Benefit Plans in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data located elsewhere in this report.

Plan Category	Number of Shares to be Issued Upon Exercise of Outstanding Awards	Weighted-Average Exercise Price of Outstanding Awards	Number of Shares Available for Future Grants
Plans approved by shareholders	4,545,195	$41.19	2,386,025
Plans not approved by shareholders	—	—	—
Total	4,545,195	$41.19	2,386,025

Stock Repurchase Plans

The Corporation has maintained several stock repurchase plans authorized by the Corporation's board of directors. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. Under the most recent plan, which expired on April 29, 2006, the Corporation was authorized to repurchase up to 2.1 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, during 2005, the Corporation repurchased 300 thousand shares at a cost of $14.4 million, all of which occurred during the first quarter. No shares were repurchased during 2006. Over the life of the plan, the Corporation repurchased a total of 833.2 thousand shares at a cost of $39.9 million.

The following table provides information with respect to purchases made by or on behalf of the Corporation or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Corporation's common stock during the fourth quarter of 2006.

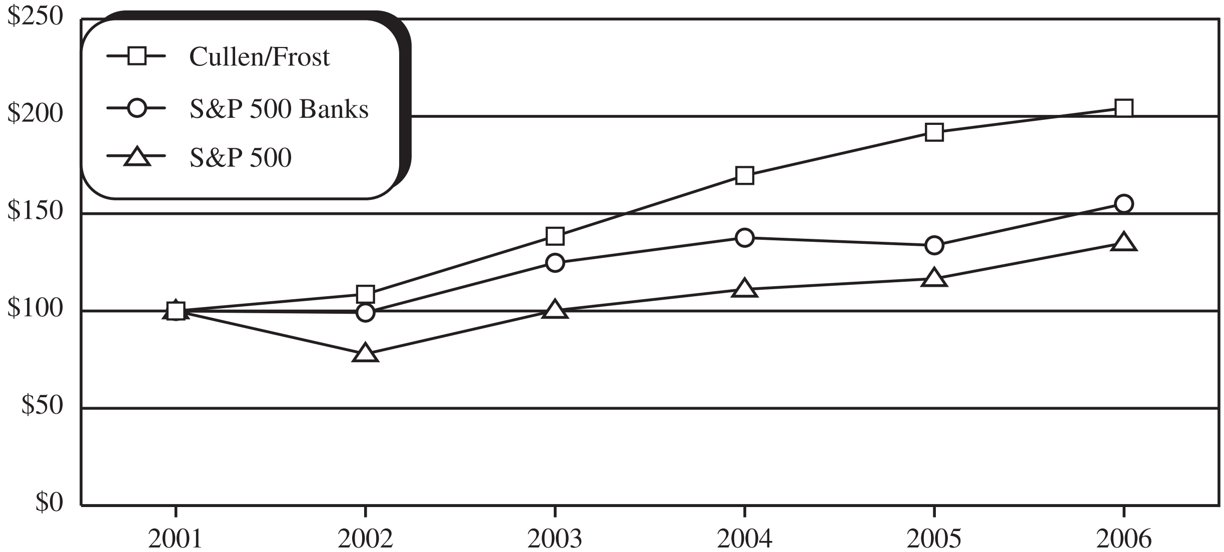
Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number of Shares That May Yet Be Purchased Under the Plans at the End of the Period
October 1, 2006 to October 31, 2006	—	$ —	—	—
November 1, 2006 to November 30, 2006	20,103(1)	54.01	—	—
December 1, 2006 to December 31, 2006	—	—	—	—
Total	20,103	$54.01	—	

(1) Includes repurchases made in connection with the exercise of certain employee stock options and the vesting of certain share awards.

Performance Graph

The performance graph below compares the cumulative total shareholder return on Cullen/Frost Common Stock with the cumulative total return on the equity securities of companies included in the Standard & Poor's 500 Stock Index and the Standard and Poor's 500 Bank Index. The graph assumes an investment of $100 on December 31, 2001 and reinvestment of dividends on the date of payment without commissions. The performance graph represents past performance and should not be considered to be an indication of future performance.

Cumulative Total Returns
on $100 Investment Made on December 31, 2001



	2001	2002	2003	2004	2005	2006
Cullen/Frost	$100.00	$108.60	$138.42	$169.61	$191.84	$204.22
S&P 500	100.00	77.95	100.27	111.15	116.60	134.97
S&P 500 Banks	100.00	99.19	124.76	137.65	133.75	155.08

ITEM 6. SELECTED FINANCIAL DATA

The following consolidated selected financial data is derived from the Corporation's audited financial statements as of and for the five years ended December 31, 2006. The following consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes included elsewhere in this report. All of the Corporation's acquisitions during the five years ended December 31, 2006 were accounted for using the purchase method. Accordingly, the operating results of the acquired companies are included with the Corporation's results of operations since their respective dates of acquisition. Dollar amounts, except per share data, and common shares outstanding are in thousands.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Consolidated Statements of Income					
Interest income:					
Loans, including fees	$502,657	$359,587	$249,612	$233,463	$265,514
Securities	144,501	131,943	135,035	125,778	120,221
Interest-bearing deposits	251	150	63	104	172
Federal funds sold and resell agreements	36,550	18,147	8,834	9,601	3,991
Total interest income	683,959	509,827	393,544	368,946	389,898
Interest expense:					
Deposits	155,090	78,934	39,150	37,406	55,384
Federal funds purchased and repurchase agreements	31,167	16,632	5,775	4,059	5,359
Junior subordinated deferrable interest debentures	17,402	14,908	12,143	8,735	8,735
Subordinated notes payable and other borrowings	11,137	8,087	5,038	4,988	6,647
Total interest expense	214,796	118,561	62,106	55,188	76,125
Net interest income	469,163	391,266	331,438	313,758	313,773
Provision for possible loan losses	14,150	10,250	2,500	10,544	22,546
Net interest income after provision for possible loan losses	455,013	381,016	328,938	303,214	291,227
Non-interest income:					
Trust fees	63,469	58,353	53,910	47,486	47,463
Service charges on deposit accounts	77,116	78,751	87,415	87,805	78,417
Insurance commissions and fees	28,230	27,731	30,981	28,660	25,912
Other charges, commissions and fees	28,105	23,125	22,877	22,522	21,446
Net gain (loss) on securities transactions	(1)	19	(3,377)	40	88
Other	43,828	42,400	33,304	28,848	27,643
Total non-interest income	240,747	230,379	225,110	215,361	200,969
Non-interest expense:					
Salaries and wages	190,784	166,059	158,039	146,622	139,227
Employee benefits	46,231	41,577	40,176	38,316	34,614
Net occupancy	34,695	31,107	29,375	29,286	28,883
Furniture and equipment	26,293	23,912	22,771	21,768	22,597
Intangible amortization	5,628	4,859	5,346	5,886	7,083
Other	106,722	99,493	89,323	84,157	79,738
Total non-interest expense	410,353	367,007	345,030	326,035	312,142
Income from continuing operations before income taxes	285,407	244,388	209,018	192,540	180,054
Income taxes	91,816	78,965	67,693	62,039	57,821
Income from continuing operations	193,591	165,423	141,325	130,501	122,233
Loss from discontinued operations, net of tax	—	—	—	—	(5,247)
Net income	$193,591	$165,423	$141,325	$130,501	$116,986

	As of or for the Year Ended December 31,				
	2006	2005	2004	2003	2002
Per Common Share Data					
Basic:					
Income from continuing operations	$ 3.49	$ 3.15	$ 2.74	$ 2.54	$ 2.40
Net income	3.49	3.15	2.74	2.54	2.29
Diluted:					
Income from continuing operations	3.42	3.07	2.66	2.48	2.33
Net income	3.42	3.07	2.66	2.48	2.23
Cash dividends declared and paid	1.32	1.165	1.035	0.94	0.875
Book value	23.01	18.03	15.84	14.87	13.72
Common Shares Outstanding					
Period-end	59,839	54,483	51,924	51,776	51,295
Weighted-average shares — basic	55,467	52,481	51,651	51,442	51,001
Dilutive effect of stock compensation	1,175	1,322	1,489	1,216	1,422
Weighted-average shares — diluted	56,642	53,803	53,140	52,658	52,423
Performance Ratios					
Return on average assets:					
Income from continuing operations	1.67%	1.63%	1.47%	1.36%	1.46%
Net income	1.67	1.63	1.47	1.36	1.40
Return on average equity:					
Income from continuing operations	18.03	18.78	17.91	17.78	18.77
Net income	18.03	18.78	17.91	17.78	17.96
Net interest income to average earning assets	4.67	4.45	4.05	3.98	4.58
Dividend pay-out ratio	37.91	37.18	38.06	37.15	38.24
Balance Sheet Data					
Period-end:					
Loans	$ 7,373,384	$ 6,085,055	$5,164,991	$4,590,746	$4,518,913
Earning assets	11,460,741	10,197,059	8,891,859	8,132,479	7,709,980
Total assets	13,224,189	11,741,437	9,952,787	9,672,114	9,536,050
Non-interest-bearing demand deposits	3,699,701	3,484,932	2,969,387	3,143,473	3,229,052
Interest-bearing deposits	6,688,208	5,661,462	5,136,291	4,925,384	4,399,091
Total deposits	10,387,909	9,146,394	8,105,678	8,068,857	7,628,143
Long-term debt and other borrowings	428,636	415,422	377,677	255,845	271,257
Shareholders' equity	1,376,883	982,236	822,395	770,004	703,790
Average:					
Loans	$ 6,523,906	$ 5,594,477	$4,823,198	$4,497,489	$4,536,999
Earning assets	10,202,981	8,968,906	8,352,334	8,011,081	6,961,439
Total assets	11,581,253	10,143,245	9,618,849	9,583,829	8,353,145
Non-interest-bearing demand deposits	3,334,280	3,008,750	2,914,520	3,037,724	2,540,432
Interest-bearing deposits	5,850,116	5,124,036	4,852,166	4,539,622	4,353,878
Total deposits	9,184,396	8,132,786	7,766,686	7,577,346	6,894,310
Long-term debt and other borrowings	405,752	387,612	363,386	264,428	275,136
Shareholders' equity	1,073,599	880,640	789,073	733,994	651,273
Asset Quality					
Allowance for possible loan losses	$ 96,085	$ 80,325	$ 75,810	$ 83,501	$ 82,584
Allowance for possible loan losses to period-end loans	1.30%	1.32%	1.47%	1.82%	1.83%
Net loan charge-offs	$ 11,110	$ 8,921	$ 10,191	$ 9,627	$ 12,843
Net loan charge-offs to average loans	0.17%	0.16%	0.20%	0.21%	0.28%
Non-performing assets	$ 57,749	$ 38,927	$ 39,116	$ 52,794	$ 42,908
Non-performing assets to:					
Total loans plus foreclosed assets	0.78%	0.64%	0.76%	1.15%	0.95%
Total assets	0.44	0.33	0.39	0.55	0.45
Consolidated Capital Ratios					
Tier 1 risk-based capital ratio	11.25%	12.24%	12.83%	11.41%	10.46%
Total risk-based capital ratio	13.43	14.94	15.99	15.01	14.16
Leverage ratio	9.56	9.62	9.18	7.83	7.25
Average shareholders' equity to average total assets	9.27	8.68	8.20	7.66	7.80

The following tables set forth unaudited consolidated selected quarterly statement of operations data for the years ended December 31, 2006 and 2005. Dollar amounts are in thousands, except per share data.

	Year Ended December 31, 2006			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
Interest income	$181,974	$176,407	$168,738	$156,840
Interest expense	60,745	57,881	51,770	44,400
Net interest income	121,229	118,526	116,968	112,440
Provision for possible loan losses	3,400	1,711	5,105	3,934
Non-interest income(1)	58,400	60,566	60,750	61,031
Non-interest expense	105,595	103,610	100,679	100,469
Income before income taxes	70,634	73,771	71,934	69,068
Income taxes	22,272	23,769	23,384	22,391
Net income	$ 48,362	$ 50,002	$ 48,550	$ 46,677
Net income per common share:				
Basic	$ 0.85	$ 0.90	$ 0.88	$ 0.86
Diluted	0.84	0.88	0.86	0.83

	Year Ended December 31, 2005			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
Interest income	$146,446	$130,198	$120,260	$112,923
Interest expense	38,646	30,913	26,182	22,820
Net interest income	107,800	99,285	94,078	90,103
Provision for possible loan losses	2,950	2,725	2,175	2,400
Non-interest income(2)	56,553	58,054	57,733	58,039
Non-interest expense	95,078	91,992	89,450	90,487
Income before income taxes	66,325	62,622	60,186	55,255
Income taxes	21,408	20,167	19,502	17,888
Net income	$ 44,917	$ 42,455	$ 40,684	$ 37,367
Net income per common share:				
Basic	$ 0.83	$ 0.81	$ 0.78	$ 0.72
Diluted	0.81	0.79	0.77	0.70

(1) Includes net loss on securities transactions of $1 thousand during the first quarter of 2006.

(2) Includes net gain on securities transactions of $19 thousand during the fourth quarter of 2005.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements and Factors that Could Affect Future Results

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

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

- Local, regional, national and international economic conditions and the impact they may have on the Corporation and its customers and the Corporation's assessment of that impact.
- Changes in the level of non-performing assets and charge-offs.
- Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.
- The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board.
- Inflation, interest rate, securities market and monetary fluctuations.
- Political instability.
- Acts of war or terrorism.
- The timely development and acceptance of new products and services and perceived overall value of these products and services by users.
- Changes in consumer spending, borrowings and savings habits.
- Changes in the financial performance and/or condition of the Corporation's borrowers.
- Technological changes.
- Acquisitions and integration of acquired businesses.
- 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.

The Corporation

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 wholly owned subsidiaries (collectively referred to as the “Corporation”), a broad array of products and services throughout numerous Texas markets. The Corporation offers commercial and consumer banking services, as well as trust and investment management, investment banking, insurance brokerage, leasing, asset-based lending, treasury management and item processing services.

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. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. While the Corporation bases estimates on historical experience, current information and other factors deemed to be relevant, actual results could differ from those estimates.

The Corporation considers accounting estimates to be critical to reported financial results if (i) the accounting estimate requires management to make assumptions about matters that are highly uncertain and (ii) different estimates that management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, could have a material impact on the Corporation’s financial statements.

Accounting policies related to the allowance for possible loan losses are considered to be critical, as these policies involve considerable subjective judgment and estimation by management. 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 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 Statement of Financial Accounting Standards (SFAS) No. 114, “Accounting by Creditors for Impairment of a Loan,” as amended by SFAS 118, and allowance allocations determined in accordance with SFAS No. 5, “Accounting for Contingencies.” 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. 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. See the section captioned “Allowance for Possible Loan Losses” elsewhere in this discussion for further details of the risk factors considered by management in estimating the necessary level of the allowance for possible loan losses.

Overview

The following discussion and analysis presents the more significant factors affecting the Corporation's financial condition as of December 31, 2006 and 2005 and results of operations for each of the years in the three-year period ended December 31, 2006. This discussion and analysis should be read in conjunction with the Corporation's consolidated financial statements, notes thereto and other financial information appearing elsewhere in this report. 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.

Taxable-equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 35% federal tax rate, thus making tax-exempt yields comparable to taxable asset yields.

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

Results of Operations

Net income totaled $193.6 million, or $3.42 diluted per common share, in 2006 compared to $165.4 million, or $3.07 diluted per common share, in 2005 and $141.3 million, or $2.66 diluted per common share, in 2004. Selected income statement data, returns on average assets and average equity and dividends per share for the comparable periods were as follows:

	2006	2005	2004
Taxable-equivalent net interest income	$479,138	$398,938	$337,102
Taxable-equivalent adjustment	9,975	7,672	5,664
Net interest income	469,163	391,266	331,438
Provision for possible loan losses	14,150	10,250	2,500
Non-interest income	240,747	230,379	225,110
Non-interest expense	410,353	367,007	345,030
Income before income taxes	285,407	244,388	209,018
Income taxes	91,816	78,965	67,693
Net income	$193,591	$165,423	$141,325
Earnings per common share:			
Basic	$ 3.49	$ 3.15	$ 2.74
Diluted	3.42	3.07	2.66
Return on average assets	1.67%	1.63%	1.47%
Return on average equity	18.03	18.78	17.91

Net income for 2006 increased $28.2 million, or 17.0%, compared to 2005. The increase was primarily due to a $77.9 million increase in net interest income and a $10.4 million increase in non-interest income. The impact of these items was partly offset by a $43.3 million increase in non-interest expense, a $12.9 million increase in income tax expense and a $3.9 million increase in the provision for possible loan losses. Net income for 2005 increased $24.1 million, or 17.1%, compared to 2004. The increase was primarily due to a $59.8 million increase in net interest income and a $5.3 million increase in non-interest income. The impact of these items was partly offset by a $22.0 million increase in non-interest expense, an $11.3 million increase in income tax expense and a $7.8 million increase in the provision for possible loan losses.

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

Net Interest Income

Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest income is the Corporation's largest source of revenue, representing 66.1% of total revenue during 2006. Net interest margin is the taxable-equivalent net interest income as a percentage of 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 2004 at 4.00% and increased 25 basis points at end of the second quarter, 50 basis points during the third quarter and 50 basis points during the fourth quarter and ended the year at 5.25%. During 2005, the prime interest rate increased 50 basis points in each of the four quarters to end the year at 7.25%. During 2006, the prime interest rate increased 50 basis points in the first quarter and 50 basis points in the second quarter to end the year at 8.25%. The federal funds rate, which is the cost of immediately available overnight funds, fluctuated in a similar manner. It began 2004 at 1.00% and increased 25 basis points at the end of the second quarter, 50 basis points during the third quarter and 50 basis points during the fourth quarter to end the year at 2.25%. During 2005, the federal funds rate increased 50 basis points in each of the four quarters to end the year at 4.25%. During 2006, the federal funds rate increased 50 basis points in the first quarter and 50 basis points in the second quarter to end the year at 5.25%.

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

The following table presents the changes in taxable-equivalent net interest income and identifies the changes due to differences in the average volume of earning assets and interest-bearing liabilities and the changes due to changes in the average interest rate on those assets and liabilities. The changes in net interest income due to changes in both average volume and average interest rate have been allocated to the average volume change or the average interest rate change in proportion to the absolute amounts of the change in each. The Corporation's consolidated average balance sheets along with an analysis of taxable-equivalent net interest income are presented on pages 112 and 113 of this report.

	2006 vs. 2005			2005 vs. 2004		
	Increase (Decrease) Due to Change in			Increase (Decrease) Due to Change in		
	Rate	Volume	Total	Rate	Volume	Total
Interest-bearing deposits	$ 155	$ (54)	$ 101	$ 92	$ (5)	$ 87
Federal funds sold and resell agreements	6,633	11,770	18,403	11,563	(2,250)	9,313
Securities:						
Taxable	4,474	7,333	11,807	1,334	(5,956)	(4,622)
Tax-exempt	(58)	1,222	1,164	(394)	2,777	2,383
Loans	66,202	78,758	144,960	55,385	55,745	111,130
Total earning assets	77,406	99,029	176,435	67,980	50,311	118,291
Savings and interest checking	1,221	349	1,570	1,782	137	1,919
Money market deposit accounts	28,660	15,257	43,917	18,471	5,179	23,650
Time accounts	11,088	11,219	22,307	9,339	987	10,326
Public funds	6,033	2,329	8,362	3,708	181	3,889
Federal funds purchased and repurchase agreements	6,709	7,826	14,535	5,340	5,517	10,857
Junior subordinated deferrable interest debentures	2,209	285	2,494	1,724	1,040	2,764
Subordinated notes payable and other notes	2,365	—	2,365	2,652	—	2,652
Federal Home Loan Bank advances	22	663	685	(11)	409	398
Total interest-bearing liabilities	58,307	37,928	96,235	43,005	13,450	56,455
Changes in net interest income	$19,099	$61,101	$ 80,200	$24,975	$36,861	$ 61,836

Taxable-equivalent net interest income for 2006 increased $80.2 million, or 20.1%, compared to 2005. The increase primarily resulted from an increase in the average volume of earning assets combined with an increase in the net interest margin. The average volume of earning assets for 2006 increased $1.2 billion compared to 2005. Over the same time frame, the net interest margin increased 22 basis points from 4.45% in 2005 to 4.67% in 2006. The increase in the average volume of earning assets was due in part to recent acquisitions (see Note 2 — Mergers and Acquisitions). The increase in the net interest margin was primarily driven by an increase in the average yield on earning assets, which increased from 5.77% during 2005 to 6.76% during 2006. The increase in the average yield on earning assets was partly due to an increase in the relative proportion of loans, which generally carry higher yields compared to other types of earning assets. Loans increased from 62.4% of total average earning assets during 2005 to 63.9% of total average earning assets during 2006. The increase in the net interest margin was also partly due to the aforementioned increases in market interest rates.

Taxable-equivalent net interest income for 2005 increased $61.8 million, or 18.3%, compared to 2004. The increase primarily resulted from an increase in the average volume of earning assets combined with an increase in the net interest margin. The average volume of earning assets for 2005 increased $616.6 million compared to 2004. Over the same time frame, the net interest margin increased 40 basis points from 4.05% in 2004 to 4.45% in 2005. The increase in the net interest margin was primarily driven by an increase in the average yield on earning assets, which increased from 4.79% during 2004 to 5.77% during 2005. The increase in the average yield on earning assets was partly the result of the Corporation having a larger proportion of average earning assets invested in higher-yielding loans during 2005 compared to 2004. The increase was also partly due to the aforementioned increases in market interest rates.

During 2004, the Corporation utilized dollar-roll repurchase agreement transactions to increase net interest income. A dollar-roll repurchase agreement is similar to an ordinary repurchase agreement, except that the security transferred is a mortgage-backed security and the repurchase provisions of the transaction agreement explicitly allow for the return of a “similar” security rather than the identical security initially sold. The Corporation funded investments in federal funds sold and resell agreements utilizing dollar-roll repurchase agreements. By doing this, the Corporation was able to capitalize on the spread between the yield earned on federal funds sold and resell agreements and the cost of the dollar-roll repurchase agreements. The spread had a positive effect on the dollar amount of net interest income, which increased by approximately $989 thousand during 2004 as a result of the dollar-roll transactions. However, because the funds were invested in lower yielding federal funds sold and resell agreements, the dollar-roll transactions had a negative impact on the Corporation’s net interest margin. The average volume of dollar-roll transactions totaled $92.3 million in 2004. The Corporation was not a party to any dollar-roll transactions during 2006 and 2005.

The average volume of loans, the Corporation’s primary category of earning assets, increased $929.4 million, or 16.6%, during 2006 compared to 2005 and increased $771.3 million, or 16.0%, during 2005 compared to 2004. The average yield on loans was 7.76% during 2006 compared to 6.46% during 2005 and 5.19% during 2004. As stated above, the Corporation had a larger proportion of average earning assets invested in loans during both 2006 compared 2005 and 2005 compared to 2004. 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 $109.0 million in 2006 compared to 2005 and decreased $111.6 million in 2005 compared to 2004. The average yield on securities was 5.00% during 2006 compared to 4.84% during 2005 and 4.77% during 2004. The fluctuations in securities average balances during the comparable years were primarily in U.S. government agency securities and U.S. Treasury securities. The decline in the average volume of securities during 2005 was primarily due to the use of available funds to support loan growth. Average federal funds sold and resell agreements increased $197.3 million during 2006 compared to the 2005 and decreased $42.6 million during 2005 compared to 2004. The average yield on federal funds sold and resell agreements was 5.08% during 2006 compared to 3.48% during 2005 and 1.57% during 2004.

Average deposits increased $1.1 billion during 2006 compared to 2005 and $366.1 million in 2005 compared to 2004. The increase in the average volume of deposits during 2006 was due in part to recent acquisitions (see Note 2 — Mergers and Acquisitions). The increase in average deposits over the comparable years was primarily in interest-bearing deposits. Average interest-bearing deposits increased $726.1 million during 2006 compared to 2005 and $271.9 million during 2005 compared to 2004. The ratio of average interest-bearing deposits to total average deposits was 63.7% during 2006 compared to 63.0% in 2005 and 62.5% in 2004. The average cost of interest-bearing deposits and total deposits was 2.65% and 1.69% during 2006 compared to 1.54% and 0.97% during 2005 and 0.81% and 0.50% during 2004. The increase in the average cost of interest-bearing deposits was primarily the result of increases in interest rates offered on deposit products due to increases in market interest rates. Additionally, the relative proportion of lower-cost savings and interest checking to total interest-bearing deposits has trended downward during the comparable periods.

The Corporation’s net interest spread, which represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities, was 3.70% in 2006 compared to 3.83% in 2005 and 3.72% in 2004. 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 7A. 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, 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 17 — 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 7A. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

Provision for Possible Loan Losses

The provision for possible loan losses is determined by management as the amount to be added to the allowance for possible loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable losses within the existing loan portfolio. The provision for possible loan losses totaled $14.2 million in 2006 compared to $10.3 million in 2005 and $2.5 million in 2004. 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:

	2006	2005	2004
Trust fees	$ 63,469	$ 58,353	$ 53,910
Service charges on deposit accounts	77,116	78,751	87,415
Insurance commissions and fees	28,230	27,731	30,981
Other charges, commissions and fees	28,105	23,125	22,877
Net gain (loss) on securities transactions	(1)	19	(3,377)
Other	43,828	42,400	33,304
Total	$240,747	$230,379	$225,110

Total non-interest income for 2006 increased $10.4 million, or 4.5%, compared to 2005 while total non-interest income for 2005 increased $5.3 million, or 2.3%, compared to 2004. Changes in the various components of non-interest income are discussed in more detail below.

Trust Fees. Trust fee income for 2006 increased $5.1 million, or 8.8%, compared to 2005 while trust fee income for 2005 increased $4.4 million, or 8.2%, compared to 2004. Investment fees are the most significant component of trust fees, making up approximately 70% of total trust fees during the reported years. 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 increase in trust fee income during 2006 compared to 2005 was primarily the result of increases in investment fees (up $3.1 million), oil and gas trust management fees (up $994 thousand), custody fees (up $566 thousand) and estate fees (up $358 thousand). The increase in investment fees was primarily due to higher equity valuations during 2006 compared to 2005 and growth in overall trust assets and the number of trust accounts. The increase in oil and gas trust management fees was partly due to increased market prices, new production and new lease bonuses.

The increase in trust fee income during 2005 compared to 2004 was primarily the result of increases in investment fees (up $2.8 million), oil and gas trust management fees (up $1.1 million) and custody fees (up $215 thousand). These increases were partly offset by a decrease in securities lending income (down $208 thousand). The increases in investment fees were primarily due to higher equity valuations during 2005 compared to 2004 and growth in overall trust assets and the number of trust accounts. The increase in oil and gas trust management fees was primarily related to higher market prices for these commodities.

At December 31, 2006, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (42.3% of trust assets), equity securities (40.4% of trust assets) and cash equivalents (10.9% of trust assets). The estimated fair value of trust assets was $23.2 billion (including managed assets of $9.3 billion and custody assets of $13.9 billion) at December 31, 2006 compared to $18.1 billion (including managed assets of $8.3 billion and custody assets of $9.8 billion) at December 31, 2005 and $17.1 billion (including managed assets of $7.8 billion and custody assets of $9.3 billion) at December 31, 2004.

Service Charges on Deposit Accounts. Service charges on deposit accounts for 2006 decreased $1.6 million, or 2.1%, compared to 2005. The decrease was primarily related to service charges on commercial accounts (down $4.0 million) and consumer accounts (down $561 thousand) partly offset by increases in overdraft/insufficient funds charges on consumer accounts (up $1.8 million) and commercial accounts (up $620 thousand). The decrease in service charges on commercial accounts was primarily related to decreased treasury management fees. The decreased treasury management fees resulted primarily from a higher earnings credit rate. The earnings credit rate is the value given to deposits maintained by treasury management customers. Because interest rates have trended upwards since the first quarter of 2004, deposit balances have become more valuable and have been yielding higher earnings credit rates relative to 2005. As a result, customers are able to pay for more of their services with earning credits applied to their deposit balances rather than through fees. The decrease in treasury management fees resulting from the higher earnings credit rate was partly offset by the additional fees from an increase in billable services. The increase in overdraft/insufficient funds charges on both commercial and consumer accounts was partly the result of growth in deposit accounts.

Service charges on deposit accounts for 2005 decreased $8.7 million, or 9.9%, compared to 2004. The decrease was primarily due to decreases in service charges on commercial accounts (down $7.7 million), service charges on consumer accounts (down $1.3 million) and overdraft/insufficient funds charges on commercial accounts (down $359 thousand). These decreases were partly offset by an increase in overdraft/insufficient funds charges on consumer accounts (up $567 thousand). The decrease in service charges on commercial accounts was primarily related to decreased treasury management fees resulting from higher earnings credit rates.

Insurance Commissions and Fees. Insurance commissions and fees for 2006 increased $499 thousand, or 1.8%, compared to 2005. The increase was primarily related to higher commission income (up $770 thousand) partly offset by a decrease in contingent commissions (down $271 thousand).

Insurance commissions and fees for 2005 decreased $3.3 million, or 10.5%, compared to 2004. Commission revenues related to the employee benefits business in the Austin region decreased compared to 2004 (down $3.4 million) due to the loss of certain revenue-producing employees and related business. Revenues related to the affected line of business made up approximately 4.5% of the total insurance commissions and fees reported for 2005 compared to 16.2% for 2004. During the second quarter of 2005, the Corporation recognized income, which is included in other non-interest income in the accompanying consolidated statements of income, of $2.4 million related to the net proceeds from the settlement of legal claims against certain of the former employees. Property and casualty revenues in the Austin region were also negatively impacted in 2005 compared to 2004 (down $1.6 million) by the loss of certain revenue-producing employees during the second half of 2004 and early 2005. The decrease in revenues from the Austin region during 2005 was partly offset by the additional commission income (up $2.0 million in 2005) related to an insurance agency acquired in the Dallas region during the third quarter of 2004. Additional information related to the acquisition of the insurance agency is presented in Note 2 — Mergers and Acquisitions in the accompanying notes to consolidated financial statements included elsewhere in this report.

Insurance commissions and fees include contingent commissions totaling $3.1 million during 2006 compared to $3.4 million during 2005 and $3.1 million during 2004. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers. The carriers use several non-client specific factors to determine the amount of the contingency payments. Such factors include the aggregate loss performance of insurance policies previously placed and the volume of business, among other things. Such commissions are seasonal in nature and are mostly received during the first quarter of each year. These commissions totaled $2.8 million during both 2006 and 2005 and $2.3 million during 2004. 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 $376 thousand, $584 thousand and $849 thousand during 2006, 2005 and 2004.

Other Charges, Commissions and Fees. Other charges, commissions and fees for 2006 increased $5.0 million, or 21.5%, compared to 2005. The increase was primarily related to an increase in investment banking fees related to corporate advisory services (up $2.8 million) and increases in commission income related to the sale of money market accounts (up $846 thousand) and mutual funds (up $645 thousand). These increases were partially offset by decreases in letter of credit fees (down $616 thousand). During the second quarter of 2006, the Corporation recognized investment banking fees related to corporate advisory services totaling $2.8 million, which was primarily related to a single transaction. During the third quarter of 2006, the Corporation recognized investment banking fees related to corporate advisory services totaling $1.3 million, which was primarily related to two transactions. Investment banking fees related to corporate advisory services are transaction based and can vary significantly from quarter to quarter.

Other charges, commissions and fees for 2005 did not significantly fluctuate compared to 2004. During 2005 compared to 2004, increases in letter of credit fees (up $959 thousand) and mutual fund fees (up $524 thousand) combined with an increase in the accelerated realization of deferred loan fees resulting from loan paydowns (up $325 thousand) were for the most part offset by a decrease in investment banking fees related to corporate advisory services (down $1.2 million), as well as decreases in various other categories of service charges and fees.

Net Gain/Loss on Securities Transactions. During 2006, the Corporation realized a net loss on securities transactions of $1 thousand related to the sales of available-for-sale securities with an amortized cost totaling $26.9 million. During 2005, the Corporation realized a net gain on securities transactions of $19 thousand related to the sales of available-for-sale securities with an amortized cost totaling $19.8 million. During 2004, the Corporation realized a net loss on securities transactions of $3.4 million. During the third quarter of 2004, the Corporation sold $228.5 million (amortized cost) of callable U.S. government agency securities, which resulted in approximately $1.6 million of the net loss. After the sales, the Corporation had no callable U.S. government agency securities. The net loss on securities transactions also included a net loss of $1.7 million related to the sale of $366.4 million (amortized cost) of securities during the first quarter of 2004. This portion of the net loss was primarily related to $176.3 million (amortized cost) of securities sold in connection with a restructuring of the Corporation's securities portfolio.

Other Non-Interest Income. Other non-interest income increased $1.4 million, or 3.4%, in 2006 compared to 2005. During 2005, the Corporation realized $2.4 million in income from the net proceeds from the settlement of legal claims against certain former employees who were employed within the employee benefits line of business in the Austin region of Frost Insurance Agency. Also during 2005, the Corporation recognized $2.0 million in income related to a distribution received from the sale of the PULSE EFT Association whereby the Corporation and other members of the Association received distributions based in part upon each member's volume of transactions through the PULSE network. Excluding the income related to these items during 2005, other non-interest income for 2006 increased $5.8 million, or 15.3%, compared to 2005. Contributing to the effective increase during 2006 were increases in income from check card usage (up $2.7 million), earnings on cashier's check balances (up $1.5 million), income from securities trading activities (up $521 thousand) and mineral interest income (up $462 thousand).

Other non-interest income increased $9.1 million, or 27.3%, in 2005 compared to 2004. The increase was impacted by the recognition of the aforementioned $2.4 million settlement and $2.0 million in PULSE EFT distributions. Also contributing to the increase were increases in income from check card usage (up $2.0 million), lease rental income (up $1.1 million), earnings on cashier's check balances (up $1.1 million) and gains realized on sales of student loans (up $822 thousand). The impact of these items was partly offset by decreases in mineral interest income (down $499 thousand) and income from securities trading activities (down $356 thousand). Also, during 2004, other non-interest income included $1.1 million in non-recurring income related to the termination and settlement of an operational contract.

Non-Interest Expense

The components of non-interest expense were as follows:

	2006	2005	2004
Salaries and wages	$190,784	$166,059	$158,039
Employee benefits	46,231	41,577	40,176
Net occupancy	34,695	31,107	29,375
Furniture and equipment	26,293	23,912	22,771
Intangible amortization	5,628	4,859	5,346
Other	106,722	99,493	89,323
Total	$410,353	$367,007	$345,030

Total non-interest expense for 2006 increased $43.3 million, or 11.8%, compared to 2005 while total non-interest expense for 2005 increased $22.0 million, or 6.4%, compared to 2004. Changes in the various components of non-interest expense are discussed below.

Salaries and Wages. Salaries and wages expense for 2006 increased $24.7 million, or 14.9%, compared to 2005. The increase was partly related to normal, annual merit increases and an increase in headcount. The increase in headcount was primarily related to the acquisition of Horizon Capital Bank (Horizon) during the fourth quarter of 2005, the acquisitions of Texas Community Bancshares (TCB) and Alamo Corporation of Texas (Alamo) during the first quarter of 2006 and the acquisition of Summit Bancshares (Summit) during the fourth quarter of 2006. Also, effective January 1, 2006, the Corporation began recognizing compensation expense related to stock options in connection with the adoption of a new accounting standard, as further discussed in Note 13 — Employee Benefit Plans. Stock-based compensation expense related to stock options and non-vested stock awards totaled $9.2 million during 2006 compared to $2.0 million during 2005.

Salaries and wages expense for 2005 increased $8.0 million, or 5.1%, compared to 2004. The increase was partly related to normal, annual merit increases, an increase in headcount and an increase in the incentive compensation accrual. The increase was also partly due to increases in stock-based compensation expense for non-vested stock awards (up $609 thousand) and overtime expenses (up $473 thousand). The increase in salaries and wages expense was partly offset by decreases in salaries and wages related to Frost Insurance Agency. Salaries and wages for Frost Insurance Agency were down due to a decrease in commissions paid because of lower insurance revenues and a decrease in headcount.

Employee Benefits. Employee benefits expense for 2006 increased $4.7 million, or 11.2%, compared to 2005. The increase was primarily related to increases in medical insurance expense (up $1.8 million), payroll taxes (up $1.4 million), expenses related to the Corporation's defined benefit retirement and restoration plans (up $796 thousand) and expenses related to the Corporation's 401(k) and profit sharing plans (up $718 thousand). The increase in employee benefits expense for 2006 was also partly the result of increases in headcount related to the acquisition of Horizon during the fourth quarter of 2005, the acquisitions of TCB and Alamo during the first quarter of 2006 and the acquisition of Summit during the fourth quarter of 2006.

Employee benefits expense for 2005 increased $1.4 million, or 3.5%, compared to 2004. The increase was primarily due to increases in expenses related to the Corporation's 401(k) and profit sharing plans (up $1.0 million) and payroll taxes (up $595 thousand), partly offset by a decrease in expense related to the Corporation's defined benefit retirement and restoration plans (down $328 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 help 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. Employee benefits expense related to the defined benefit retirement and restoration plans totaled $2.7 million in 2006, $1.9 million in 2005 and $2.3 million in 2004. Future expense related to these plans is dependent upon a variety of factors, including the actual return on plan assets.

For additional information related to the Corporation's employee benefit plans, see Note 13 — Employee Benefit Plans in the accompanying notes to consolidated financial statements included elsewhere in this report.

Net Occupancy. Net occupancy expense for 2006 increased $3.6 million, or 11.5%, compared to 2005. The increase was primarily related to increases in utilities expenses (up $739 thousand), property taxes (up $591 thousand), depreciation expense related to buildings (up $586 thousand) and in lease expense (up $565 thousand), as well as increases in various other categories of occupancy expense. These increases were partly related to the additional facilities added in connection with recent acquisitions during the fourth quarter of 2005 and the first and fourth quarters of 2006 (see Note 2 — Mergers and Acquisitions).

Net occupancy expense for 2005 increased $1.7 million, or 5.9%, compared to 2004. The increase was primarily related to increases in utilities expenses (up $740 thousand) and depreciation expense related to buildings (up $432 thousand), a decrease in rental income (down $231 thousand) and increases in various other categories of occupancy expense. These increases were partly offset by a decrease in depreciation expense related to leasehold improvements (down $276 thousand), as well as decreases in various other categories of occupancy expense.

Furniture and Equipment. Furniture and equipment expense for 2006 increased $2.4 million, or 10.0%, compared to 2005. The increase was primarily due to increases in software maintenance (up $1.9 million), depreciation expense related to furniture and fixtures (up $1.4 million) and service contracts expense (up $698 thousand). The impact of these items was partly offset by a decrease in software amortization expense (down $1.9 million). The increase in software maintenance and depreciation expense related to furniture and fixtures was partly due to management's decision to no longer outsource certain data processing functions.

Furniture and equipment expense for 2005 increased $1.1 million, or 5.0%, compared to 2004. The increase was primarily due to increases in software maintenance (up $902 thousand) and depreciation expense related to furniture and fixtures (up $473 thousand) partly offset by a decrease in software amortization expense (down $265 thousand).

Intangible Amortization. Intangible amortization is primarily related to core deposit intangibles and, to a lesser extent, intangibles related to non-compete agreements and customer relationships. Intangible amortization totaled $5.6 million for 2006 compared to $4.9 million for 2005 and $5.3 million for 2004. Intangible amortization for 2006 increased $769 thousand, or 15.8%, compared to 2005 primarily due to the amortization of new intangible assets acquired in connection with recent acquisitions during the fourth quarter of 2005 and the first and fourth quarters of 2006 (see Note 2 — Mergers and Acquisitions and Note 7 — Goodwill and Other Intangible Assets).

Intangible amortization for 2005 decreased $487 thousand, or 9.1%, compared to 2004 primarily due to the completion of the amortization for certain intangible assets. The decrease was partly offset by additional amortization related to intangible assets recorded during the fourth quarter of 2005 in connection with the acquisition of Horizon (see Note 2 — Mergers and Acquisitions and Note 7 — Goodwill and Other Intangible Assets).

During 2005, the Corporation wrote-off certain customer relationship intangibles totaling $147 thousand and goodwill totaling $2.0 million in connection with the settlement of legal claims against certain former employees of Frost Insurance Agency. Gross settlement proceeds of $4.5 million were reduced by the write-off of these assets in the determination of the $2.4 million net proceeds recognized in the settlement. See the analysis of other non-interest income in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Other Non-Interest Expense. Other non-interest expense for 2006 increased $7.2 million, or 7.3%, compared to 2005. Components of the increase during 2006 included professional service expense (up $5.1 million), amortization of net deferred costs associated with unfunded loan commitments (up $2.2 million), check card expense (up $1.3 million), stationary, printing and supplies expense (up $1.1 million), travel expense (up $930 thousand), meals and entertainment expense (up $866 thousand) and write-downs of other real estate owned (up $743 thousand), among other things. The increases in professional services expense, stationary, printing and supplies expense, travel expense and meals and entertainment expense were partly related to acquisitions and integration activities. The increase in these items was partly offset by a decrease in outside computer service expense (down $6.3 million). The reduction in outside computer services resulted as the Corporation is no longer outsourcing certain data processing functions.

Other non-interest expense for 2005 increased $10.2 million, or 11.4%, compared to the same period in 2004. Significant components of the increase during 2005 included increases in professional service expense (up $2.5 million), advertising/promotions expense (up $1.7 million), donations (up $1.0 million), depreciation expense related to property leased to customers (up $852 thousand), travel expense (up $850 thousand), meals and entertainment expense (up $725 thousand) and stationary, printing and supplies expense (up $577 thousand). These expenses were partially offset by lower business development expense (down $399 thousand), bank service charges (down $256 thousand), property taxes on foreclosed assets (down $187 thousand), and federal reserve service charges (down $162 thousand).

Results of Segment Operations

The Corporation's operations are managed along two operating segments: Banking and the Financial Management Group ("FMG"). A description of each business and the methodologies used to measure financial performance is described in Note 19 — Operating Segments in the accompanying notes to consolidated financial statements included elsewhere in this report. Net income (loss) by operating segment is presented below:

	2006	2005	2004
Banking	$184,141	$159,177	$137,744
Financial Management Group	22,652	16,666	10,997
Non-Banks	(13,202)	(10,420)	(7,416)
Consolidated net income	$193,591	$165,423	$141,325

Banking

Net income for 2006 increased $25.0 million, or 15.7%, compared to 2005. The increase was primarily the result of a $71.8 million increase in net interest income and a $2.6 million increase in non-interest income partly offset by a $35.3 million increase in non-interest expense, a $10.3 million increase in income tax expenses and a $4.0 million increase in the provision for possible loan losses. Net income for 2005 increased $21.4 million, or 15.6%, compared to 2004. The increase was primarily the result of a $53.6 million increase in net interest income partly offset by a $15.5 million increase in non-interest expense, a $8.5 million increase in income taxes and a $7.7 million increase in the provision for possible loan losses.

Net interest income for 2006 increased $71.8 million, or 18.3%, compared to 2005 while net interest income for 2005 increased $53.6 million, or 15.8%, compared to 2004. The increases primarily resulted from growth in the average volume of earning assets combined with increases in the net interest margin which resulted, in part, from a general increase in market interest rates and an increase in the relative proportion of higher-yielding loans as a percentage of total average earning assets. See the analysis of net interest income included in the section captioned "Net Interest Income" included elsewhere in this discussion.

The provision for possible loan losses for 2006 totaled $14.2 million compared to $10.2 million in 2005 and $2.5 million in 2004. 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 2006 increased $2.6 million, or 1.6%, compared to 2005. The decrease was primarily due to increases in other charges, commissions and fees partly offset by a decrease in service charges on deposit accounts. Non-interest income for 2005 decreased $503 thousand, or 0.3%, compared to 2004. Non-interest income for 2004 included a $3.4 million net loss on securities transactions. Excluding the net loss, non-interest income would have decreased $3.9 million. This effective decrease was primarily due to decreases in service charges on deposit accounts and insurance commissions and fees partly offset by an increase in other non-interest income. See the analysis of service charges on deposit accounts, insurance commissions and fees and other non-interest income included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Non-interest expense for 2006 increased $35.3 million, or 11.6%, compared to 2005. The increase was primarily related to increases in salaries and wages, employee benefits expense, net occupancy expense, furniture and equipment expense and other non-interest expense. Combined, salaries and wages and employee benefits increased $24.7 million during 2006 compared to 2005. This increase was primarily the result of normal, annual merit increases, increases in headcount as well as increases in medical insurance expense, payroll taxes, expenses related to the Corporation's employee benefit plans and stock-based compensation expense. Other non-interest expense increased $3.9 million, or 5.5%, primarily due to increases in professional service expenses, amortization of net deferred costs associated with unfunded loan commitments, check card expense, stationary, printing and supplies expense, travel expenses and meals and entertainment expense, among other things. These increases were partly offset by a decrease in outside computer service expense. The increase in net occupancy expense was primarily due to an increase in utilities expenses, property taxes, depreciation expense related to buildings and lease expense. The increase in furniture and equipment expense was primarily due to increases in software maintenance expense, depreciation expense related to furniture and fixtures and service contracts expense partly offset by a decrease in software amortization expense. The increases in net occupancy expense and furniture and equipment expense are partly related to the additional facilities added in connection with recent acquisitions during the fourth quarter of 2005 and the first and fourth quarters of 2006 (see Note 2 — Mergers and Acquisitions). See the analysis of these items included in the section captioned "Non-Interest Expense" included elsewhere in this discussion.

Non-interest expense for 2005 increased $15.5 million, or 5.4%, compared to 2004. The increase was primarily related to increases in salaries and wages, employee benefits expense and other non-interest expense. Combined, salaries and wages and employee benefits during 2005 increased $6.9 million compared to 2004. This increase was primarily the result of normal, annual merit increases, as well as increases in headcount, the incentive compensation accrual, stock-based compensation expense for non-vested stock awards, overtime, expenses related to the Corporation's employee benefit plans and payroll taxes. The increase in salaries and wages expense during 2005 was partly offset by a decrease in salaries and wages related to Frost Insurance Agency due to a decrease in commissions paid because of lower insurance revenues and a decrease in headcount. Other non-interest expense increased $6.2 million, or 9.6%, primarily due to increases in professional service expenses, advertising/promotional expenses, donations, depreciation expense related to property leased to customers, travel expenses and meals and entertainment expense, among other things. 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 segment, had gross commission revenues of $28.6 million in 2006 compared to $28.1 million in 2005 and $31.4 million in 2004. Insurance commission revenues increased $517 thousand, or 1.8%, during 2006 compared to 2005. The increase during 2006 compared to 2005 was primarily related to higher commission income (up $787 thousand) partly offset by a decrease in contingent commission income (down $270 thousand). Insurance commission revenues decreased $3.3 million, or 10.5%, during 2005 compared to 2004. The decrease during 2005 compared to 2004 was primarily the result of lower commissions in the Austin region due to the loss of certain revenue-producing employees and increased competition. The decrease in commissions in the Austin region was partly offset by additional commission income related to an insurance agency acquired in the Dallas region during the third quarter of 2004. See the analysis of insurance commissions and fees included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Financial Management Group (FMG)

Net income for 2006 increased $6.0 million, or 35.9%, compared to 2005. The increase was primarily due to a $8.6 million increase in net interest income and a $7.7 million increase in non-interest income partly offset by a $7.1 million increase in non-interest expense and a $3.2 million increase in income tax expense. Net income for 2005 increased $5.7 million, or 51.6%, compared to 2004. The increase was primarily due to a $9.0 million increase in net interest income and a $6.1 million increase in non-interest income partly offset by a $6.3 million increase in non-interest expense and a $3.1 million increase in income taxes.

Net interest income for 2006 increased $8.6 million, or 6.1% compared to 2005. Net interest income for 2005 increased $9.0 million, or 179.7% compared to 2004. The increases during both 2006 and 2005 resulted from increases in the average volume of repurchase agreements as well as increases in average market interest rates, which impacted the funds transfer price paid on FMG's repurchase agreements.

Non-interest income for 2006 increased $7.7 million, or 10.9%, compared to 2005 while non-interest income for 2005 increased $6.1 million, or 9.5%, compared to 2004. The increases were primarily due to increases in trust fees (up $5.3 million in 2006 and $4.6 million in 2005).

Trust fee income is the most significant income component for FMG. Investment fees are the most significant component of trust fees, making up approximately 70% of total trust fees for both 2006 and 2005 and 71% of total trust fees for 2004. Investment and other custodial account fees are generally based on the market value of assets within a trust account. Volatility in the equity and bond markets impacts the market value of trust assets and the related investment fees. FMG has experienced an increasing trend in investment fees since 2004 primarily due to higher equity valuations and growth in overall trust assets and the number of trust accounts. See the analysis of trust fees included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Non-interest expense for 2006 increased $7.1 million, or 12.1%, compared to 2005 while non-interest expense for 2005 increased $6.3 million, or 12.0%, compared to 2004. The increases were primarily due to increases in salaries and wages and employee benefits and other non-interest expense. The increases in salaries and wages and employee benefits (on a combined basis, up $4.0 million in 2006 and $2.4 million in 2005) were primarily the result of normal, annual merit increases, increases in headcount and increases in expenses related to stock-based compensation, payroll taxes, medical insurance and employee benefit plans. The increases in other non-interest expense (up $3.1 million in 2006 and $3.9 million in 2005) were primarily due to general increases in the various components of other non-interest expense, including cost allocations.

Non-Banks

The net loss for the Non-Banks segment increased $2.8 million during 2006 compared to 2005. The increase was primarily due to a decrease in net interest income due in part to the variable-rate junior subordinated deferrable interest debentures issued in February 2004. As market interest rates have increased, the Non-Banks segment has experienced a corresponding increase in interest cost related to this debt. Additionally, during 2006, the Corporation had added interest cost from the $3.1 million of variable-rate junior subordinated deferrable interest debentures acquired in connection with the acquisition of Alamo in the first quarter and $12.4 million of variable-rate junior subordinated deferrable interest debentures acquired in connection with the acquisition of Summit in the fourth quarter.

The net loss for the Non-Banks segment increased $3.0 million during 2005 compared to 2004. The increase was primarily due to a decrease in net interest income due in part to the variable-rate junior subordinated deferrable interest debentures issued in February 2004. As market interest rates have increased, the Non-Banks segment has experienced a corresponding increase in interest cost related to this debt. Additionally, 2004 did not include a full year of interest cost related to this debt as it was issued during the first quarter of that year.

Income Taxes

The Corporation recognized income tax expense of $91.8 million, for an effective tax rate of 32.2% for 2006 compared to $79.0 million, for an effective rate of 32.3%, in 2005 and $67.7 million, for an effective rate of 32.4%, in 2004. 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.

Sources and Uses of Funds

The following table illustrates, during the years presented, the mix of the Corporation's funding sources and the assets in which those funds are invested as a percentage of the Corporation's average total assets for the period indicated. Average assets totaled $11.6 billion in 2006 compared to $10.1 billion in 2005 and $9.6 billion in 2004.

	2006	2005	2004
Sources of Funds:			
Deposits:			
Non-interest-bearing	28.8%	29.7%	30.3%
Interest-bearing	50.5	50.5	50.4
Federal funds purchased and repurchase agreements	6.6	6.0	5.9
Long-term debt and other borrowings	3.5	3.8	3.8
Other non-interest-bearing liabilities	1.3	1.3	1.4
Equity capital	9.3	8.7	8.2
Total	100.0%	100.0%	100.0%
Uses of Funds:			
Loans	56.3%	55.1%	50.1%
Securities	25.5	28.1	30.8
Federal funds sold, resell agreements and other interest-earning assets	6.3	5.2	5.9
Other non-interest-earning assets	11.9	11.6	13.2
Total	100.0%	100.0%	100.0%

Deposits continue to be the Corporation's primary source of funding. Although trending down as a percentage of total funding sources, non-interest-bearing deposits remain a significant source of funding, which has been a key factor in maintaining the Corporation's relatively low cost of funds. Non-interest-bearing deposits totaled 36.3% of total average deposits in 2006 compared to 37.0% in 2005 and 37.5% in 2004. The decrease in the relative proportion of non-interest-bearing deposits to total deposits was partly due to decreases in average correspondent bank deposits (see related information regarding this decrease in the section captioned "Deposits" included elsewhere in this discussion). Federal funds purchased and repurchase agreements increased in relative proportion during 2006 in part due to a $167.5 million increase in repurchase agreements.

The Corporation primarily invests funds in loans and securities. Loans continue to be the largest component of the Corporation's mix of invested assets. Average loans increased $929.4 million, or 16.6%, in 2006 compared to 2005 and $771.3 million, or 16.0%, in 2005 compared to 2004. The increase in 2006 and 2005 was partly due to the acquisition of $326.3 million in loans in connection with the acquisition of Horizon during the fourth quarter of 2005, $289.6 million in loans in connection with the acquisition of TCB and Alamo during the first quarter of 2006 and $824.5 million in loans in connection with the acquisition of Summit during the fourth quarter of 2006. Excluding the impact of the loans acquired in these acquisitions, average loans increased $379.0 million, or 6.9%, in 2006 compared to 2005. The increase in 2005 compared to 2004 was partly due to improved loan demand that appeared to be the result of improved economic conditions and the movement of business from other lenders to the Corporation. See additional information regarding the Corporation's loan portfolio in the section captioned "Loans" included elsewhere in this discussion. The relative proportion of funds invested in securities in 2006 decreased compared to 2005, while the relative proportion of funds invested in federal funds sold, resell agreements and other interest-earning assets increased as the Corporation chose to delay the reinvestment of funds in longer-term securities until more favorable investment yields became available. The relative proportion of funds invested in securities as well as federal funds sold, resell agreements and other interest-earning assets during 2005 compared to 2004 decreased in part to provide funding for loan growth.

Loans

Year-end loans were as follows:

	2006	Percentage of Total	2005	2004	2003	2002
Commercial and industrial:						
Commercial	$3,229,570	43.8%	$2,610,178	$2,361,052	$2,081,631	$2,048,089
Leases	174,075	2.4	148,750	114,016	77,909	57,642
Asset-based	33,856	0.4	41,288	34,687	36,683	49,819
Total commercial and industrial	3,437,501	46.6	2,800,216	2,509,755	2,196,223	2,155,550
Real estate:						
Construction:						
Commercial	649,140	8.8	590,635	419,141	349,152	315,340
Consumer	114,142	1.5	87,746	37,234	23,399	45,152
Land:						
Commercial	407,055	5.5	301,907	215,148	178,022	158,271
Consumer	5,394	0.1	10,369	3,675	5,169	8,231
Commercial mortgages	1,766,469	24.0	1,409,811	1,185,431	1,102,138	1,050,957
1-4 family residential mortgages	125,294	1.7	95,032	86,098	113,756	179,077
Home equity and other consumer	508,574	6.9	460,941	387,864	292,255	276,429
Total real estate	3,576,068	48.5	2,956,441	2,334,591	2,063,891	2,033,457
Consumer:						
Indirect	3,475	0.1	2,418	3,648	8,358	25,262
Student loans held for sale	47,335	0.6	51,189	63,568	58,280	43,430
Other	310,752	4.2	265,038	247,025	246,173	245,760
Other	27,703	0.4	27,201	21,819	28,962	23,295
Unearned discount	(29,450)	(0.4)	(17,448)	(15,415)	(11,141)	(7,841)
Total	$7,373,384	100.0%	$6,085,055	$5,164,991	$4,590,746	$4,518,913

Overview. Loans totaled $7.4 billion at December 31, 2006 increasing $1.3 billion, or 21.2%, compared to December 31, 2005. During 2006, the Corporation acquired $1.1 billion in loans in connection with the acquisitions of TCB, Alamo and Summit. Excluding these acquired loans, total loans increased $174.2 million, or 2.9%.

The Corporation stopped originating mortgage and indirect consumer loans during 2000, and as such, these portfolios are excluded when analyzing the growth of the loan portfolio. Student loans are similarly excluded because the Corporation primarily originates these loans for resale. Accordingly, student loans are classified as held for sale. Excluding 1-4 family residential mortgages, the indirect lending portfolio and student loans, loans increased $1.3 billion, or 21.2% from December 31, 2005.

The majority of the Corporation's loan portfolio is comprised of commercial and industrial loans and real estate loans. Commercial and industrial loans made up 46.6% and 46.0% of total loans while real estate loans made up 48.5% and 48.6% of total loans at December 31, 2006 and 2005, respectively. Real estate loans include both commercial and consumer balances. Of the $1.1 billion of loans acquired in connection with the acquisition of TCB, Alamo and Summit, approximately 33% were commercial and industrial loans and approximately 62% were real estate loans.

Loan Origination/Risk Management. The Corporation has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, the Corporation's management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. As detailed in the discussion of real estate loans below, the properties securing the Corporation's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Corporation's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At December 31, 2006, approximately 60% of the outstanding principal balance of the Corporation's commercial real estate loans were secured by owner-occupied properties.

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Corporation may originate from time to time, the Corporation generally requires the borrower to have had an existing relationship with the Corporation and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Corporation until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Corporation originates consumer loans utilizing a computer-based credit scoring analysis to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

The Corporation maintains an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Corporation's policies and procedures.

Commercial and Industrial Loans. Commercial and industrial loans increased $637.3 million, or 22.8% from $2.8 billion at December 31, 2005 to $3.4 billion at December 31, 2006. During 2006, the Corporation acquired approximately $363 million of commercial and industrial loans in connection with the acquisitions of TCB, Alamo and Summit. The Corporation's commercial and industrial loans are a diverse group of loans to small, medium and large businesses. The purpose of these loans varies from supporting seasonal working capital needs to term financing of equipment. While some short-term loans may be made on an unsecured basis, most are secured by the assets being financed with collateral margins that are consistent with the Corporation's loan policy guidelines. The commercial and industrial loan portfolio also includes the commercial lease and asset-based lending portfolios as well as purchased shared national credits ("SNCs"), which are discussed in more detail below.

Industry Concentrations. As of December 31, 2006 and 2005, there were no concentrations of loans within any single industry in excess of 10% of total loans, as segregated by Standard Industrial Classification code ("SIC code"). The SIC code is a federally designed standard industrial numbering system used by the Corporation to categorize loans by the borrower's type of business. The following table summarizes the industry concentrations of the Corporation's loan portfolio, as segregated by SIC code. Industry concentrations are stated as a percentage of year-end total loans as of December 31, 2006 and 2005:

	2006	2005
Industry concentrations:		
Energy	8.0%	7.3%
Medical services	5.7	5.6
Building construction	4.4	3.9
Services	4.1	3.6
General and specific trade contractors	3.5	3.0
Public finance	3.5	2.8
Manufacturing, other	3.4	3.2
Legal services	2.4	3.2
Insurance	2.4	2.1
Restaurants	2.1	2.5
All other (34 categories in 2006 and 2005)	60.5	62.8
Total loans	100.0%	100.0%

The Corporation's largest concentration in any single industry is in energy. Year-end energy loans were as follows:

	2006	2005
Energy loans:		
Production	$424,474	$307,709
Service	116,018	117,255
Traders	12,501	8,271
Manufacturing	32,929	11,557
Refining	721	—
Total energy loans	$586,643	$444,792

Large Credit Relationships. The market areas served by the Corporation include three of the top ten most populated cities in the United States. These market areas are also home to a significant number of Fortune 500 companies. As a result, the Corporation originates and maintains large credit relationships with numerous commercial customers in the ordinary course of business. The Corporation considers large credit relationships to be those with commitments equal to or in excess of $10.0 million, excluding treasury management lines exposure, prior to any portion being sold. Large relationships also include loan participations purchased if the credit relationship with the agent is equal to or in excess of $10.0 million. In addition to the Corporation's normal policies and procedures related to the origination of large credits, the Corporation's Central Credit Committee (CCC) must approve all new and renewed credit facilities which are part of large credit relationships. The CCC meets regularly and reviews large credit relationship activity and discusses the current pipeline, among other things. The following table provides additional information on the Corporation's large credit relationships outstanding at year-end.

	2006			2005		
	Number of Relationships	Period-End Balances Committed	Period-End Balances Outstanding	Number of Relationships	Period-End Balances Committed	Period-End Balances Outstanding
Large credit relationships:						
$20.0 million and greater	91	$2,616,299	$1,318,739	57	$1,656,205	$843,163
$10.0 million to $19.9 million. .	123	1,694,956	921,942	119	1,649,324	984,011

Growth in outstanding balances related to credit relationships in excess of $20.0 million resulted from an increase in commitments. Approximately $695.6 million of the net increase in these commitments was related to newly reported large credit relationships. The Corporation acquired approximately $49 million in commitments in excess of $20.0 million and approximately $71 million of commitments in excess of $10.0 million but less than $20.0 million in connection with the acquisition of Summit during the fourth quarter of 2006. The average commitment in excess of $20 million per large credit relationship did not significantly fluctuate and totaled $28.8 million at December 31, 2006 and $29.1 million at December 31, 2005. The average outstanding balance per large credit relationship with a commitment in excess of $20.0 million totaled $14.5 million at December 31, 2006 and $14.8 million at December 31, 2005.

Purchased Shared National Credits. Purchased 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 $360.1 million at December 31, 2006, increasing from $331.6 million at December 31, 2005. At December 31, 2006, 52.4% of outstanding purchased SNCs was related to the energy industry and 19.7% of outstanding SNCs was related to the beer and liquor distribution industry. The remaining purchased SNCs were diversified throughout various other industries, with no other single industry exceeding 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 real estate categories. 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. The following table provides additional information about certain credits within the Corporation's purchased SNCs portfolio as of year-end.

	2006			2005		
	Number of Relationships	Period-End Balances Committed	Period-End Balances Outstanding	Number of Relationships	Period-End Balances Committed	Period-End Balances Outstanding
Purchased shared national credits:						
$20.0 million and greater	17	$427,700	$215,478	13	$320,292	$155,896
$10.0 million to $19.9 million. .	18	247,250	129,151	19	283,015	152,568

Real Estate Loans. Real estate loans totaled $3.6 billion at December 31, 2006, an increase of $619.6 million, or 21.0%, compared to $3.0 billion at December 31, 2005. During 2006, the Corporation acquired approximately $695 million of real estate loans in connection with the acquisitions of TCB, Alamo and Summit. Commercial real estate loans totaled $2.8 billion, or 78.9% of total real estate loans, at December 31, 2006 and $2.3 billion or 77.9% of total real estate loans, at December 31, 2005. 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 the 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.

The following tables summarize the Corporation's commercial real estate loan portfolio, as segregated by (i) the type of property securing the credit and (ii) the geographic region in which the property is located. Property type concentrations are stated as a percentage of year-end total commercial real estate loans as of December 31, 2006 and 2005:

	2006	2005
Property type:		
Office building	21.3%	16.9%
Office/warehouse	13.1	15.3
1-4 family	10.3	8.5
Medical offices and services	5.9	6.5
Retail	5.1	6.4
Religious	4.1	5.1
All other	40.2	41.3
Total commercial real estate loans	100.0%	100.0%
Geographic region:		
Fort Worth	29.8%	19.1%
Houston	22.3	28.7
San Antonio	18.9	20.9
Dallas	9.2	11.7
Austin	7.8	9.0
Rio Grande Valley	6.6	4.3
Corpus Christi	5.4	6.3
Total commercial real estate loans	100.0%	100.0%

Consumer Loans. The consumer loan portfolio, including all consumer real estate, totaled $1.1 billion at December 31, 2006, increasing $142.2 million, or 14.6%, from $972.7 million at December 31, 2005. During 2006, the Corporation acquired approximately $56 million of consumer loans in connection with the acquisitions of TCB, Alamo and Summit. Excluding 1-4 family residential mortgages, indirect loans and student loans, total consumer loans increased $114.8 million, or 13.9%, from December 31, 2005.

As the following table illustrates as of year-end, 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.

	2006	2005
Construction	$ 114,142	$ 87,746
Land	5,394	10,369
Home equity loans	241,680	237,789
Home equity lines of credit	87,103	78,401
Other consumer real estate	179,791	144,751
Total consumer real estate	628,110	559,056
Consumer non-real estate	310,752	265,038
Student loans held for sale	47,335	51,189
Indirect	3,475	2,418
1-4 family residential mortgages	125,294	95,032
Total consumer loans	$1,114,966	$972,733

Consumer real estate loans, excluding 1-4 family mortgages, increased $69.1 million, or 12.4%, from December 31, 2005. Home equity loans were first permitted in the State of Texas beginning January 1, 1998. During September 2003, Texas voters approved an amendment to the Texas constitution that permitted financial institutions to offer home equity lines of credit. As a result, the Corporation added home equity lines of credit to its loan offerings and began originating such lines in the fourth quarter of 2003. Combined, home equity loans and lines of credit made up 52.3% and 56.6% of the consumer real estate loan total at December 31, 2006 and 2005. The Corporation offers home equity loans up to 80% of the estimated value of the personal residence of the borrower, less the value of existing mortgages and home improvement loans.

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 primarily originates student loans for resale. Accordingly, these loans are considered "held for sale." Student loans are included in total loans in the consolidated balance sheet. Student loans are generally sold on a non-recourse basis after the deferment period has ended; however, from time to time, the Corporation has sold such loans prior to the end of the deferment period. The Corporation sold approximately $70.3 million of student loans during 2006 compared to $73.2 million during 2005 and $55.9 million during 2004.

The indirect consumer loan segment has continued to decrease since the Corporation's decision to discontinue originating these types of loans during 2000. Indirect loans increased $1.1 million during 2006 compared to 2005 as a result of loans acquired in connection with the acquisitions of TCB, Alamo and Summit.

The Corporation also discontinued originating 1-4 family residential mortgage loans in 2000. This portfolio will continue to decline due to the decision to withdraw from the mortgage origination business. 1-4 family residential mortgage loans increased $30.3 million during 2006 compared to 2005 as a result of loans acquired in connection with the acquisitions of TCB, Alamo and Summit.

Foreign Loans. The Corporation makes 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 December 31, 2006 or 2005.

Maturities and Sensitivities of Loans to Changes in Interest Rates. The following table presents the maturity distribution of the Corporation's loans, excluding 1-4 family residential real estate loans, student loans and unearned discounts, at December 31, 2006. The table also presents the portion of loans that have fixed interest rates or variable interest rates that fluctuate over the life of the loans in accordance with changes in an interest rate index such as the prime rate or LIBOR.

	Due in One Year or Less	After One, but Within Five Years	After Five Years	Total
Commercial and industrial	$1,662,765	$1,451,271	$ 323,465	$3,437,501
Real estate construction	379,295	235,074	148,913	763,282
Commercial real estate and land	385,037	1,076,995	711,492	2,173,524
Consumer and other	173,768	257,686	424,444	855,898
Total	$2,600,865	$3,021,026	$1,608,314	$7,230,205
Loans with fixed interest rates	$ 717,500	$1,101,987	$ 828,147	$2,647,634
Loans with floating interest rates	1,883,365	1,919,039	780,167	4,582,571
Total	$2,600,865	$3,021,026	$1,608,314	$7,230,205

The Corporation may renew loans at maturity when requested by a customer whose financial strength appears to support such renewal or when such renewal appears to be in the Corporation's best interest. In such instances, the Corporation generally requires payment of accrued interest and may adjust the rate of interest, require a principal reduction or modify other terms of the loan at the time of renewal.

Non-Performing Assets and Potential Problem Loans

Non-Performing Assets. Year-end non-performing assets and accruing past due loans were as follows:

	2006	2005	2004	2003	2002
Non-accrual loans:					
Commercial and industrial	$20,813	$25,556	$27,089	$35,914	$19,878
Real estate	29,580	4,963	2,471	10,766	7,167
Consumer and other	1,811	2,660	883	771	7,816
Total non-accrual loans	52,204	33,179	30,443	47,451	34,861
Restructured loans	—	—	—	—	—
Foreclosed assets:					
Real estate	5,500	4,403	7,369	5,054	8,005
Other	45	1,345	1,304	289	42
Total foreclosed assets	5,545	5,748	8,673	5,343	8,047
Total non-performing assets	$57,749	$38,927	$39,116	$52,794	$42,908
Ratio of non-performing assets to:					
Total loans and foreclosed assets	0.78%	0.64%	0.76%	1.15%	0.95%
Total assets	0.44	0.33	0.39	0.55	0.45
Accruing past due loans:					
30 to 89 days past due	$56,836	$32,908	$20,895	$24,419	$30,766
90 or more days past due	10,917	7,921	5,231	14,462	9,081
Total accruing past due loans	$67,753	$40,829	$26,126	$38,881	$39,847
Ratio of accruing past due loans to total loans:					
30 to 89 days past due	0.77%	0.54%	0.41%	0.53%	0.68%
90 or more days past due	0.15	0.13	0.10	0.32	0.20
Total accruing past due loans	0.92%	0.67%	0.51%	0.85%	0.88%

Non-performing assets include non-accrual loans, restructured loans and foreclosed assets. Non-performing assets at December 31, 2006 increased $18.8 million from December 31, 2005. The increase was primarily related to two commercial real estate loans totaling $23.2 million placed on non-accrual status during the fourth quarter of 2006. These loans were first reported as potential problem loans during the third quarter of 2006.

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. Loans to a customer whose financial condition has deteriorated are considered for non-accrual status whether or not the loan is 90 days or more past due. For consumer loans, collectibility and loss are generally determined before the loan reaches 90 days past due. Accordingly, losses on consumer loans are recorded at the time they are determined. Consumer loans that are 90 days or more past due are generally either in liquidation/payment status or bankruptcy awaiting confirmation of a plan. 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. Classification of a loan as non-accrual does not preclude the ultimate collection of loan principal or interest.

Restructured loans are loans on which, due to deterioration in the borrower's financial condition, the original terms have been modified in favor of the borrower or either principal or interest has been forgiven.

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. 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. As of December 31, 2006, the Corporation had $12.7 million in loans of this type which are not included in either of the non-accrual or 90 days past due loan categories. At December 31, 2006, potential problem loans consisted of five credit relationships. Of the total outstanding balance at December 31, 2006, approximately 62.2% related to a customer in the insurance industry, approximately 18.2% related to a customer that operates as a retailer of musical instruments and approximately 14.4% related to a customer that operates as a retailer of game room furnishings. Weakness in these companies' operating performance has caused the Corporation to heighten the attention given to these credits.

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 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 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. 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.

The Corporation's allowance for possible loan losses consists of three elements: (i) specific valuation allowances determined in accordance with SFAS 114 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with SFAS 5 based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) general valuation allowances determined in accordance with SFAS 5 based on general economic conditions and other qualitative risk factors both internal and external to the Corporation.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of classified loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. Loans with a calculated grade that is below a predetermined grade are adversely classified. Once a loan is classified, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for possible loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things. If after review, a specific valuation allowance is not assigned to the loan, and the loan is not considered to be impaired, the loan is included with a pool of similar loans that is assigned a historical valuation allowance calculated based on historical loss experience.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Corporation calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Corporation's pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer loans and 1-4 family residential mortgages.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Corporation. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the bank's lending management and staff; (ii) the effectiveness of the Corporation's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; and (ix) the impact of rising interest rates on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a "general allocation matrix" to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.

The table below provides an allocation of the year-end allowance for possible loan losses by loan type; however, allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories:

	2006		2005		2004		2003		2002	
	Allowance for Possible Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Possible Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Possible Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Possible Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Possible Loan Losses	Percentage of Loans in each Category to Total Loans
Commercial and industrial	$44,603	46.2%	$50,357	45.7%	$49,696	48.4%	$42,504	47.6%	$45,618	47.6%
Real estate	24,955	48.5	16,378	48.6	12,393	45.1	19,752	45.0	13,928	44.9
Consumer	8,238	4.9	5,303	5.2	4,436	6.1	3,920	6.8	4,609	7.0
Other	2,125	0.4	1,556	0.5	1,081	0.4	1,217	0.6	1,801	0.5
Unallocated	16,164	—	6,731	—	8,204	—	16,108	—	16,628	—
Total	$96,085	100.0%	$80,325	100.0%	$75,810	100.0%	$83,501	100.0%	$82,584	100.0%

During 2006, the reserve allocation related to real estate loans increased compared to 2005 primarily due to growth in the real estate loan portfolio and an increase in specific valuation allowances determined in accordance with SFAS 114. The overall growth in real estate loans included growth in several of the higher-risk categories of real estate loans, which resulted in higher reserve allocations to compensate for the additional concentration risk. The decrease in the reserve allocation for commercial and industrial loans during 2006 compared to 2005 was primarily due to a decrease in the level of criticized commercial and industrial loans and a decrease in specific valuation allowances determined in accordance with SFAS 114 partly offset by growth in the commercial and industrial loan portfolio. The increase in the reserve allocation for consumer loans during 2006 compared to 2005 was primarily due to growth in the consumer loan portfolio. The overall growth in loans resulted in an increase in historical valuation allowances determined in accordance with SFAS 5 based on historical loan loss experience for similar loans with similar characteristics and trends. The reserves allocated in accordance with SFAS 5 for all types of loans were also impacted by an increase in the relative percentage by which the historical valuation allowances are adjusted to compensate for current qualitative risk factors. Specific valuation allowances determined in accordance with SFAS 114 related to real estate loans increased approximately $2.7 million in 2006 compared to 2005. Specific valuation allowances determined in accordance with SFAS 114 related to commercial and industrial loans decreased approximately $2.1 million in 2006 compared to 2005. Specific valuation allowances for other types of loans were not significant at December 31, 2006. The increase in the unallocated portion of the allowance for possible loan losses during 2006 compared to 2005 was partly related to the relative uncertainty of the credit quality of certain loans acquired in connection with the acquisition of Summit during the fourth quarter of 2006.

During 2005, the reserve allocation related to real estate loans increased compared to 2004 primarily due to growth in the real estate loan portfolio combined with an increase in the level of criticized loans. The overall growth in real estate loans included growth in several of the higher-risk categories of real estate loans, which resulted in higher reserve allocations to compensate for the additional concentration risk. The increase in the reserve allocation for commercial and industrial loans during 2005 compared to 2004 was primarily due to an increase in the level of criticized loans combined with growth in the commercial and industrial loan portfolio. The growth in real estate and commercial and industrial loans as well as the level of criticized loans in these portfolios resulted in an increase in historical valuation allowances determined in accordance with SFAS 5 based on historical loan loss experience for similar loans with similar characteristics and trends. The reserves allocated in accordance with SFAS 5 for all types of loans were impacted by a reduction in the relative percentage by which the historical valuation allowances are adjusted to compensate for current qualitative risk factors. Specific valuation allowances determined in accordance with SFAS 114 related to commercial and industrial loans decreased approximately $2.1 million in 2005 compared to 2004. Specific valuation allowances for other types of loans were not significant at December 31, 2005.

During 2004, reserve allocations for commercial and industrial loans increased compared to 2003 despite a decline in the level of criticized loans. The increase in reserve allocations was the result of portfolio growth and increases in historical valuation allowances determined in accordance with SFAS 5 based on historical loan loss experience for similar loans with similar characteristics and trends. Specific valuation allowances determined in accordance with SFAS 114 related to commercial and industrial loans decreased in 2004 compared to 2003. The reserve allocations related to real estate loans increased in 2003 primarily due to increases in specific valuation allowances. These allocations were reduced in 2004 as many of the loans were repaid, charged-off or reclassified due to improved performance. The reserve allocations for commercial loans were increased in 2002 in response to the softening economy during 2001. Also, during 2002 the Corporation assessed the impact on consumer loan losses of the decision in 2000 to exit indirect consumer lending. Since exiting indirect lending, consumer loan losses have declined significantly. In response to this decline in loan losses, the consumer reserve allocation was reduced in line with the lower risk in the consumer portfolio.

The unallocated reserve increased in 2002 in response to deterioration in the economy. The deteriorating economic conditions helped create a higher risk environment for loan portfolios. The Corporation responded to this higher risk environment by increasing unallocated reserves based on risk factors thought to increase with the slowing economy. During 2004, improving economic conditions appeared to reduce the overall risk environment for loan portfolios. Furthermore, the Corporation began to experience positive trends in several important credit quality measures including the levels of past due loans, potential problem loans and criticized assets. As a result, the level of unallocated reserve was decreased in 2004 through a reduction in the provision for loan losses, as further discussed below, and a reallocation of amounts to commercial and industrial loans as discussed above.

Activity in the allowance for possible loan losses is presented in the following table. There were no charge-offs or recoveries related to foreign loans during any of the periods presented.

	2006	2005	2004	2003	2002
Balance of allowance for possible loan losses at beginning of year	$ 80,325	$ 75,810	$ 83,501	$ 82,584	$ 72,881
Provision for possible loan losses	14,150	10,250	2,500	10,544	22,546
Allowance for possible loan losses acquired	12,720	3,186	—	—	—
Charge-offs:					
Commercial and industrial	(10,983)	(8,448)	(12,570)	(11,627)	(13,112)
Real estate	(727)	(531)	(2,724)	(1,607)	(2,249)
Consumer and other	(7,223)	(6,126)	(4,721)	(3,761)	(3,363)
Total charge-offs	(18,933)	(15,105)	(20,015)	(16,995)	(18,724)
Recoveries:					
Commercial and industrial	3,019	2,409	6,219	5,581	3,940
Real estate	483	351	718	272	452
Consumer and other	4,321	3,424	2,887	1,515	1,489
Total recoveries	7,823	6,184	9,824	7,368	5,881
Net charge-offs	(11,110)	(8,921)	(10,191)	(9,627)	(12,843)
Balance at end of year	$ 96,085	$ 80,325	$ 75,810	$ 83,501	$ 82,584
Net charge-offs as a percentage of average loans	0.17%	0.16%	0.20%	0.21%	0.28%
Allowance for possible loan losses as a percentage of year-end loans	1.30	1.32	1.47	1.82	1.83
Allowance for possible loan losses as a percentage of year-end non-accrual loans	184.1	242.1	249.0	176.0	236.9
Average loans outstanding during the year	$6,523,906	$5,594,477	$4,823,198	$4,497,489	$4,536,999
Loans outstanding at year-end	7,373,384	6,085,055	5,164,991	4,590,746	4,518,913
Non-accrual loans outstanding at year-end	52,204	33,179	30,443	47,451	34,861

As stated above, the provision for possible loan losses reflects loan quality trends, including the level of net charge-offs or recoveries, among other factors. The provision for possible loan losses increased $3.9 million in 2006 to $14.2 million compared to $10.3 million in 2005 and increased $7.8 million in 2005 compared to $2.5 million in 2004. The increase in the provision for possible loan losses in 2006 was primarily due to growth in the loan portfolio. The provision for possible loan losses increased in 2005 in part due to an increase in the level of criticized loans. The increase in the provision for possible loan losses in 2005 was also partly due to the overall growth in the loan portfolio. During 2004, the lower provision levels reflect the fact that the Corporation was experiencing positive trends in several important credit quality measures including the levels of past due loans, potential problem loans and criticized assets. The Corporation did not record a provision for possible loan losses in the third or fourth quarters of 2004 primarily due to a reduction in the overall level of criticized loans.

Net charge-offs in 2006 increased $2.2 million compared to 2005 while net charge-offs in 2005 decreased $1.3 million compared to 2004. Net charge-offs as a percentage of average loans increased one basis point in 2006 compared to 2005 and decreased four basis points in 2005 compared to 2004.

Management believes the level of the allowance for possible loan losses was adequate as of December 31, 2006. 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.

Securities

Year-end securities were as follows:

	2006		2005		2004	
	Amount	Percentage of Total	Amount	Percentage of Total	Amount	Percentage of Total
Held to maturity:						
U.S. government agencies and corporations	$ 9,096	0.3%	$ 11,701	0.4%	$ 15,614	0.6%
Other	1,000	—	1,000	—	1,100	—
Total	10,096	0.3	12,701	0.4	16,714	0.6
Available for sale:						
U.S. Treasury	89,683	2.7	84,309	2.7	—	—
U.S. government agencies and corporations	2,902,609	86.6	2,676,103	87.0	2,676,796	89.9
States and political subdivisions	310,376	9.3	271,293	8.8	252,145	8.5
Other	28,285	0.8	27,406	0.9	28,355	0.9
Total	3,330,953	99.4	3,059,111	99.4	2,957,296	99.3
Trading:						
U.S. Treasury	8,515	0.3	6,217	0.2	4,671	0.1
States and political subdivisions	891	—	—	—	—	—
Total	9,406	0.3	6,217	0.2	4,671	0.1
Total securities	$3,350,455	100.0%	$3,078,029	100.0%	$2,978,681	100.0%

The following tables summarize the maturity distribution schedule with corresponding weighted-average yields of securities held to maturity and securities available for sale as of December 31, 2006. Weighted-average yields have been computed on a fully taxable-equivalent basis using a tax rate of 35%. Mortgage-backed securities and collateralized mortgage obligations are included in maturity categories based on their stated maturity date. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Other securities classified as available for sale include stock in the Federal Reserve Bank and the Federal Home Loan Bank, which have no maturity date. These securities have been included in the total column only.

	Within 1 Year		1-5 Years		5-10 Years		After 10 Years		Total	
	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield
Held to maturity:										
U.S. government agencies and corporations	$ —	—%	$ 459	8.42%	$ 392	8.59%	$ 8,245	5.51%	$ 9,096	5.79%
Other	1,000	4.10	—	—	—	—	—	—	1,000	4.10
Total	$ 1,000	4.10	$ 459	8.42	$ 392	8.59	$ 8,245	5.51	$ 10,096	5.62
Available for Sale:										
U.S. Treasury	$ 89,683	3.91%	$ —	—%	$ —	%	$ —	—%	$ 89,683	3.91%
U.S. government agencies and corporations	118,841	5.33	20,406	4.99	150,376	5.15	2,612,986	4.99	2,902,609	5.00
States and political subdivisions	5,524	6.55	96,300	6.12	118,763	6.12	89,789	6.09	310,376	6.12
Other	—	—	—	—	—	—	—	—	28,285	—
Total	$214,048	4.76	$116,706	5.92	$269,139	5.58	$2,702,775	5.02	$3,330,953	5.08

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. The remaining securities are classified as trading. Trading securities are held primarily for sale in the near term and are carried at their fair values, with unrealized gains and losses included immediately in other income. Management determines the appropriate classification of securities at the time of purchase. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost.

At December 31, 2006, there were no holdings of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of the Corporation's shareholders' equity.

The average taxable-equivalent yield of the securities portfolio was 5.00% in 2006 compared to 4.84% in 2005 and 4.77% in 2004. During 2006 and 2005, market yields on mortgage-backed securities increased as a result of the general increase in market rates as further discussed in the section captioned "Net Interest Income" included elsewhere in this discussion. The overall growth in the securities portfolio over the comparable periods was primarily funded by deposit growth.

Deposits

The table below presents the daily average balances of deposits by type and weighted-average rates paid thereon during the years presented:

	2006		2005		2004	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
Non-interest-bearing:						
Commercial and individual	$3,005,811		$2,639,071		$2,395,663	
Correspondent banks	277,332		323,712		469,635	
Public funds	51,137		45,967		49,222	
Total	3,334,280		3,008,750		2,914,520	
Interest-bearing:						
Private accounts:						
Savings and interest checking	1,283,830	0.36%	1,206,055	0.25%	1,171,883	0.09%
Money market deposit accounts	3,022,866	3.05	2,646,975	1.82	2,444,734	1.00
Time accounts of $100,000 or more	617,790	3.93	501,040	2.45	471,200	1.28
Time accounts under $100,000	505,189	3.67	393,419	2.09	393,976	1.05
Public funds	420,441	3.72	376,547	1.93	370,373	0.91
Total	5,850,116	2.65	5,124,036	1.54	4,852,166	0.81
Total deposits	$9,184,396	1.69	$8,132,786	0.97	$7,766,686	0.50

Average deposits increased $1.1 billion in 2006 compared to 2005 and increased $366.1 million in 2005 compared to 2004. Approximately $633.9 million of the increase in average deposits during 2006 compared to 2005 resulted from the Corporation's acquisition of $319.1 million of deposits in connection with the acquisition of Horizon during the fourth quarter of 2005, $381.6 million of deposits in connection with the acquisitions of TCB and Alamo during the first quarter of 2006 and $973.9 million of deposits in connection with the acquisition of Summit during the fourth quarter of 2006. The deposits acquired during 2006 included approximately $426.6 million of non-interest-bearing commercial and individual deposits and approximately $928.9 million of interest-bearing deposits (encompassing $246.1 million of savings and interest checking accounts, $314.2 million of money market accounts and $368.6 million of time accounts). The deposits acquired during 2005 included approximately $152.1 million of non-interest-bearing commercial and individual deposits and approximately $167.0 million of interest-bearing deposits (encompassing $44.6 million of savings and interest checking accounts, $56.7 million of money market accounts and $65.7 million of time accounts). Approximately $75.2 million of the increase in average deposits during 2005 compared to 2004 was due to the deposits acquired in connection with the acquisition of Horizon.

The increase in average deposits over the comparable years was primarily in average interest-bearing deposits. The ratio of average interest-bearing deposits to total average deposits increased to 63.7% in 2006 from 63.0% in 2005 and 62.5% in 2004. The average cost of interest-bearing deposits and total deposits was 2.65% and 1.69% during 2006 compared to 1.54% and 0.97% during 2005 and 0.81% and 0.50% during 2004. The increase in the average cost of interest-bearing deposits during 2006 compared to 2005 and during 2005 compared to 2004 was primarily the result of increases in interest rates offered on deposit products due to increases in market interest rates. Additionally, the relative proportion of lower-cost savings and interest checking to total interest-bearing deposits has trended downward during the comparable periods.

The following table presents the proportion of each component of average non-interest-bearing deposits to the total of such deposits during the years presented:

	2006	2005	2004
Commercial and individual	90.2%	87.7%	82.2%
Correspondent banks	8.3	10.8	16.1
Public funds	1.5	1.5	1.7
Total	100.0%	100.0%	100.0%

Average non-interest-bearing deposits increased $325.5 million, or 10.8%, in 2006 compared to 2005 while average non-interest-bearing deposits increased $94.2 million, or 3.2%, in 2005 compared to 2004. The increase in 2006 was primarily due to a $366.7 million, or 13.9%, increase in average commercial and individual demand deposits partly offset by a $46.4 million, or 14.3%, decrease in average correspondent bank deposits. The increase in average commercial and individual demand deposits was partly due to the added deposits acquired in the aforementioned acquisitions. Average commercial and individual demand deposits during 2006 and 2005 included approximately $68.6 million and $10.3 million of that were received under a contractual relationship assumed in connection with the acquisition of Horizon. The Corporation expects this contractual relationship will be terminated in 2007. The decrease in correspondent bank deposits was partly due to declines in volumes related to four large customers, the largest of which had unusually high average volumes during the latter part of 2005. The increase in 2005 was primarily due to a $243.4 million, or 10.2%, increase in average commercial and individual deposits partly offset by a $145.9 million, or 31.1%, decrease in average correspondent bank deposits. The increase in average commercial and individual deposits was primarily attributable to an increase in the number of accounts and the maintenance of higher cash balances by customers. The decrease in average correspondent bank deposits during 2005 was partly the result of the loss of deposits related to a large customer in the business of mortgage processing who was acquired by another financial institution.

The following table presents the proportion of each component of average interest-bearing deposits to the total of such deposits during the years presented:

	2006	2005	2004
Private accounts:			
Savings and interest checking	21.9%	23.5%	24.2%
Money market deposit accounts	51.7	51.7	50.4
Time accounts of $100,000 or more	10.6	9.8	9.7
Time accounts under $100,000	8.6	7.7	8.1
Public funds	7.2	7.3	7.6
Total	100.0%	100.0%	100.0%

Total average interest-bearing deposits increased $726.1 million, or 14.2%, in 2006 compared to 2005 and increased $271.9 million, or 5.6%, in 2005 compared to 2004. The growth in average deposits during 2006 was partly due to the added deposits acquired in the aforementioned acquisitions. The Corporation has experienced a shift in the relative mix of interest-bearing deposits during the comparable years as the proportion of higher-yielding time accounts and money market deposit accounts has increased while the proportion of savings and interest checking accounts has decreased. The shift in relative proportions appears to be related to the increasing interest rate environment experienced over that last two years as many customers appear to have become more inclined to invest their funds for extended periods.

Geographic Concentrations. The following table summarizes the Corporation's average total deposit portfolio, as segregated by the geographic region from which the deposit accounts were originated. Certain accounts, such as correspondent bank deposits, are recorded at the statewide level. Geographic concentrations are stated as a percentage of average total deposits during the years presented.

	2006	2005	2004
San Antonio	35.7%	38.5%	38.7%
Houston	20.4	18.8	18.1
Fort Worth	14.6	14.3	13.7
Austin	10.9	11.0	10.6
Corpus Christi	6.8	7.6	7.7
Dallas	4.9	4.3	3.8
Rio Grande Valley	4.0	1.5	1.5
Statewide	2.7	4.0	5.9
Total	100.0%	100.0%	100.0%

The Corporation experienced deposit growth in all regions during 2006 and 2005 with the exception of the Statewide region. Average deposits for the Statewide region decreased $81.5 million, or 24.9%, in 2006 compared to 2005 and $131.9 million, or 28.7%, in 2005 compared to 2004. The decreases were primarily related to the declines in correspondent bank deposits discussed above. The geographic concentrations of average deposits for certain regions was impacted by the recent acquisitions. The Houston region was impacted by the acquisition of Horizon, while the Dallas region was impacted by the acquisition of TCB, the Rio Grande Valley region was impacted by the acquisition of Alamo and the Fort Worth region was impacted by the acquisition of Summit. Excluding the impact of these acquisitions, the San Antonio region had the largest dollar volume increase during 2006 and 2005, increasing $146.5 million, or 4.7%, in 2006 compared to 2005 and $129.9 million, or 4.3%, in 2005 compared to 2004. In terms of percentage growth and excluding the impact of acquisitions, the Austin and Rio Grande Valley regions had the largest increases during 2006. Average deposits in the Austin region increased $105.1 million, or 11.7%, in 2006 compared to 2005. Average deposits in the Rio Grande Valley region increased $13.8 million, or 11.3%, in 2006 compared to 2005. During 2005, the largest percentage growth was in the Dallas and Austin regions. Average deposits in the Dallas region increased $55.0 million, or 18.5%, in 2005 compared to 2004. Average deposits in the Austin region increased $71.5 million, or 10.1%, in 2005 compared to 2004.

Foreign Deposits. Mexico has historically been considered a part of the natural trade territory of the Corporation's banking offices. Accordingly, U.S. dollar-denominated foreign deposits from sources within Mexico have traditionally been a significant source of funding. Average deposits from foreign sources, primarily Mexico, totaled $711.0 million in 2006, $641.2 million in 2005 and $666.3 million in 2004.

Short-Term Borrowings

The Corporation's primary source of short-term borrowings is federal funds purchased from correspondent banks and repurchase agreements in the natural trade territory of the Corporation, as well as from upstream banks. Federal funds purchased and repurchase agreements totaled $864.2 million, $740.5 million and $506.3 million at December 31, 2006, 2005 and 2004. The maximum amount of these borrowings outstanding at any month-end was $864.2 million in 2006, $740.5 million in 2005 and $792.8 million in 2004. The weighted-average interest rate on federal funds purchased was 5.05%, 3.93% and 2.14% at December 31, 2006, 2005 and 2004.

The following table presents the Corporation's average net funding position during the years indicated:

	2006		2005		2004	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Federal funds sold and resell agreements	$ 718,950	5.08%	$ 521,674	3.48%	$ 564,286	1.57%
Federal funds purchased and repurchase agreements	(764,173)	4.08	(605,965)	2.74	(564,489)	1.02
Net funds position	$ (45,223)		$ (84,291)		$ (203)	

The net funds purchased position decreased in 2006 compared to 2005 primarily due to a $141.7 million increase in average federal funds sold, a $55.6 million increase in average resell agreements and a $9.3 million decrease in average federal funds purchased partly offset by a $167.5 million increase in average repurchase agreements. The net funds purchased position increased in 2005 compared to 2004 primarily due to a $136.6 million increase in average repurchase agreements. The net funds purchased position was impacted in 2004 by the use of dollar-roll repurchase agreements. Average dollar-roll repurchase agreements outstanding totaled $92.3 million in 2004. There were no dollar-roll repurchase agreements outstanding in 2006 and 2005. A dollar-roll repurchase agreement is similar to an ordinary repurchase agreement, except that the security transferred is a mortgage-backed security and the repurchase provisions of the transaction agreement explicitly allow for the return of a "similar" security rather than the identical security initially sold. The basic strategy of utilizing dollar-roll repurchase agreements is to leverage earning assets to capitalize on the spread between the yield earned on federal funds sold and resell agreements and the cost of the dollar-roll repurchase agreements. This spread has a positive effect on the dollar amount of net interest income; however, because the funds are invested in lower yielding federal funds sold and resell agreements, net interest margin is negatively impacted. See the section captioned "Net Interest Income" included elsewhere in this discussion.

Off Balance Sheet Arrangements, Commitments, Guarantees, and Contractual Obligations

The following table summarizes the Corporation's contractual obligations and other commitments to make future payments as of December 31, 2006. Payments for borrowings do not include interest. Payments related to leases are based on actual payments specified in the underlying contracts. Loan commitments and standby letters of credit are presented at contractual amounts; however, since many of these commitments are expected to expire unused or only partially used, the total amounts of these commitments do not necessarily reflect future cash requirements.

	Payments Due by Period				
	1 year or less	More than 1 year but less than 3 years	3 years or more but less than 5 years	5 years or more	Total
Contractual obligations:					
Subordinated notes payable	$ —	$ —	$ —	$150,000	$ 150,000
Junior subordinated deferrable interest debentures	—	—	—	242,270	242,270
Federal Home Loan Bank advances	25,220	4,585	6,536	25	36,366
Operating leases	15,175	26,951	16,432	31,545	90,103
Deposits with stated maturity dates	1,358,650	225,002	15,076	—	1,598,728
	1,399,045	256,538	38,044	423,840	2,117,467
Other commitments:					
Commitments to extend credit	69,489	2,895,501	471,624	524,957	3,961,571
Standby letters of credit	1,607	241,457	10,191	1,520	254,775
	71,096	3,136,958	481,815	526,477	4,216,346
Total contractual obligations and other commitments	$1,470,141	$3,393,496	$519,859	$950,317	$6,333,813

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, the Corporation enters into various transactions, which, in accordance with accounting principles generally accepted in the United States, are not included in its consolidated balance sheets. The Corporation enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The Corporation minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures. The Corporation also holds certain assets which are not included in its consolidated balance sheets including assets held in fiduciary or custodial capacity on behalf of its trust customers and certain collateral funds resulting from acting as an agent in its securities lending program.

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 outstanding at December 31, 2006 are included in the table above.

Standby Letters of Credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Corporation would be required to fund the commitment. The maximum potential amount of future payments the Corporation could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, the Corporation would be entitled to seek recovery from the customer. The Corporation's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements. Standby letters of credit outstanding at December 31, 2006 are included in the table above.

Trust Accounts. The Corporation also holds certain assets in fiduciary or custodial capacity on behalf of its trust customers. The estimated fair value of trust assets was approximately $23.2 billion (including managed assets of $9.3 billion and custody assets of $13.9 billion) at December 31, 2006. These assets were primarily composed of fixed income securities (42.3% of trust assets), equity securities (40.4% of trust assets) and cash equivalents (10.9% of trust assets).

Securities Lending. The Corporation lends certain customer securities to creditworthy brokers on behalf of those customers. If the borrower fails to return these securities, the Corporation indemnifies its customers based on the fair value of the securities. The Corporation holds collateral received in securities lending transactions as an agent. Accordingly, such collateral assets are not assets of the Corporation. The Corporation requires borrowers to provide collateral equal to or in excess of 100% of the fair value of the securities borrowed. The collateral is valued daily and additional collateral is requested as necessary. The maximum future payments guaranteed by the Corporation under these contractual agreements (representing the fair value of securities lent to brokers) totaled $2.1 billion at December 31, 2006. At December 31, 2006, the Corporation held liquid assets with a fair value of $2.2 billion as collateral for these agreements.

Capital and Liquidity

Capital. At December 31, 2006, shareholders' equity totaled $1.4 billion compared to $982.2 million at December 31, 2005. In addition to net income of $193.6 million, other significant changes in shareholders' equity during 2006 included $215.3 million of common stock issued in connection with the acquisition of Summit, $73.4 million of dividends paid, $42.7 million of proceeds from stock option exercises and the related tax benefits of $16.4 million, $9.2 million related to stock-based compensation and $4.7 million in treasury stock purchases, which were primarily made in connection with the exercise of certain employee stock options and the vesting of certain share awards. The accumulated other comprehensive loss component of shareholders' equity totaled $54.9 million at December 31, 2006 compared to accumulated other comprehensive loss of $50.4 million at December 31, 2005. This fluctuation was primarily related to the after-tax effect of changes in the fair value of securities available for sale and changes in the funded status of the Corporation's defined benefit post-retirement benefit plans. Under regulatory requirements, amounts reported as accumulated other comprehensive income/loss related to the net unrealized gain or loss on securities available for sale and the funded status of the Corporation's defined benefit post-retirement benefit plans do not increase or reduce regulatory capital and are not included in the calculation of risk-based capital and leverage ratios. Regulatory agencies for banks and bank holding companies utilize capital guidelines designed to measure Tier 1 and total capital and take into consideration the risk inherent in both on-balance sheet and off-balance sheet items. See Note 12 — Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report.

The Corporation paid quarterly dividends of $0.30, $0.34, $0.34 and $0.34 per common share during the first, second, third and fourth quarters of 2006, respectively, and $0.265, $0.30, $0.30 and $0.30 per common share during the first, second, third and fourth quarters of 2005. This equates to a dividend payout ratio of 37.9% in 2006 and 37.2% in 2005.

The Corporation has maintained several stock repurchase plans authorized by the Corporation's board of directors. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. Under the most recent plan, which expired on April 29, 2006, the Corporation was authorized to repurchase up to 2.1 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, during 2005, the Corporation repurchased 300 thousand shares at a cost of $14.4 million, all of which occurred during the first quarter. No shares were repurchased during 2006. Over the life of the plan, the Corporation repurchased a total of 833.2 thousand shares at a cost of $39.9 million. Also see Part II, Item 5 — Market For

Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities, included elsewhere in this report.

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

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

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

Since Cullen/Frost is a holding company and does not conduct operations, its primary sources of liquidity are dividends upstreamed from Frost Bank and borrowings from outside sources. Banking regulations may limit the amount of dividends that may be paid by Frost Bank. See Note 12 — Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report regarding such dividends. At December 31, 2006, Cullen/Frost had liquid assets, including cash and resell agreements, totaling $104.2 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 December 31, 2006.

The Corporation expects to redeem the $100 million in trust preferred securities issued by Cullen/Frost Capital Trust I during the first quarter of 2007. As a result of the anticipated redemption, the Corporation expects to incur approximately $5.3 million in expense related to the prepayment penalty and the write-off of unamortized debt issuance costs.

Impact of Inflation and Changing Prices

The Corporation's financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). GAAP presently requires the Corporation to measure financial position and operating results primarily in terms of historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Corporation is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Corporation, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities, among other things, as further discussed in the next section.

Regulatory and Economic Policies

The Corporation's business and earnings are affected by general and local economic conditions and by the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities, among other things. The Federal Reserve Board regulates the supply of money in order to influence general economic conditions. Among the instruments of monetary policy available to the Federal Reserve

Board are (i) conducting open market operations in United States government obligations, (ii) changing the discount rate on financial institution borrowings, (iii) imposing or changing reserve requirements against financial institution deposits, and (iv) restricting certain borrowings and imposing or changing reserve requirements against certain borrowings by financial institutions and their affiliates. These methods are used in varying degrees and combinations to affect directly the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. For that reason alone, the policies of the Federal Reserve Board have a material effect on the earnings of the Corporation.

Governmental policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future; however, the Corporation cannot accurately predict the nature, timing or extent of any effect such policies may have on its future business and earnings.

Recently Issued Accounting Pronouncements

See Note 21 — 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.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The disclosures set forth in this item are qualified by Item 1A. Risk Factors and the section captioned "Forward-Looking Statements and Factors that Could Affect Future Results" included in Item 7. 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.

Market risk refers to the risk of loss arising from adverse changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates and prices, such as equity prices. The risk of loss can be assessed from the perspective of adverse changes in fair values, cash flows, and future earnings. Due to the nature of its operations, the Corporation is primarily exposed to interest rate risk and, to a lesser extent, liquidity risk.

Interest rate risk on the Corporation's balance sheets consists of reprice, option, and basis risks. Reprice risk results from differences in the maturity, or repricing, of asset and liability portfolios. Option risk arises from "embedded options" present in many financial instruments such as loan prepayment options, deposit early withdrawal options and interest rate options. These options allow customers opportunities to benefit when market interest rates change, which typically results in higher costs or lower revenue for the Corporation. Basis risk refers to the potential for changes in the underlying relationship between market rates and indices, which subsequently result in a narrowing of profit spread on an earning asset or liability. Basis risk is also present in administered rate liabilities, such as savings accounts, negotiable order of withdrawal accounts, and money market accounts where historical pricing relationships to market rates may change due to the level or directional change in market interest rates.

The Corporation seeks to avoid fluctuations in its net interest margin and to maximize net interest income within acceptable levels of risk through periods of changing interest rates. Accordingly, the Corporation's interest rate sensitivity and liquidity are monitored on an ongoing basis by its Asset and Liability Committee ("ALCO"), which oversees market risk management and establishes risk measures, limits and policy guidelines for managing the amount of interest rate risk and its effect on net interest income and capital. A variety of measures are used to provide for a comprehensive view of the magnitude of interest rate risk, the distribution of risk, the level of risk over time and the exposure to changes in certain interest rate relationships.

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 measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates 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.

The Committee continuously monitors and manages the balance between interest rate-sensitive assets and liabilities. The objective is to manage the impact of fluctuating market rates on net interest income within acceptable levels. In order to meet this objective, management may lengthen or shorten the duration of assets or liabilities or enter into derivative contracts to mitigate potential market risk.

As of December 31, 2006, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 1.6% and 2.3%, respectively, relative to the base case over the next 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 1.7% and 4.7%, respectively, relative to the base case over the next 12 months. As of December 31, 2005, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 2.0% and 3.9%, 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 1.8% and 3.8%, respectively, relative to the base case over the next 12 months. The decrease in the projected positive variance in net interest income resulting from the hypothetical 200 basis point increase in interest rates from 3.9% in 2005 to 2.3% in 2006 was partly due to the impact of longer duration fixed-rate loans acquired in connection with the acquisition of Summit Bancshares, Inc. during the fourth quarter of 2006.

See Note 2 — Mergers and Acquisitions in the accompanying notes to consolidated financial statements included elsewhere in this report. The increase in the projected negative variance in net interest income resulting from the hypothetical 200 basis point decrease in interest rates from 3.8% in 2005 to 4.7% in 2006 was partly due to the interest rate floors on variable-rate loans purchased during the fourth quarter of 2005 moving further out of the money as a result of increases in the prime interest rate during 2006. See Note 17 — Derivative Financial Instruments in the accompanying notes to consolidated financial statements included elsewhere in this report.

The impact of hypothetical fluctuations in interest rates on the Corporation's derivative holdings was not a significant portion of these variances in any of the reported periods. As of December 31, 2006, the effect of a 200 basis point increase in interest rates on the Corporation's derivative holdings would result in a 0.03% positive variance in net interest income. The effect of a 200 basis point decrease in interest rates on the Corporation's derivative holdings would result in a 0.02% negative variance in net interest income.

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Ernst & Young LLP
Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
of Cullen/Frost Bankers, Inc.

We have audited the accompanying consolidated balance sheets of Cullen/Frost Bankers, Inc. (the "Corporation") as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cullen/Frost Bankers, Inc. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, effective January 1, 2006, the Corporation adopted Statement of Financial Accounting Standards No. 123R, *Share Based Payment*, to account for stock based compensation.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Cullen/Frost Bankers, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 2, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

San Antonio, Texas
February 2, 2007

Cullen/Frost Bankers, Inc.
Consolidated Statements of Income

(Dollars in thousands, except per share amounts)

	Year Ended December 31,		
	2006	**2005**	**2004**
Interest income:			
Loans, including fees	$502,657	$359,587	$249,612
Securities:			
Taxable	133,184	121,377	125,999
Tax-exempt	11,317	10,566	9,036
Interest-bearing deposits	251	150	63
Federal funds sold and resell agreements	36,550	18,147	8,834
Total interest income	683,959	509,827	393,544
Interest expense:			
Deposits	155,090	78,934	39,150
Federal funds purchased and repurchase agreements	31,167	16,632	5,775
Junior subordinated deferrable interest debentures	17,402	14,908	12,143
Subordinated notes payable and other borrowings	11,137	8,087	5,038
Total interest expense	214,796	118,561	62,106
Net interest income	469,163	391,266	331,438
Provision for possible loan losses	14,150	10,250	2,500
Net interest income after provision for possible loan losses	455,013	381,016	328,938
Non-interest income:			
Trust fees	63,469	58,353	53,910
Service charges on deposit accounts	77,116	78,751	87,415
Insurance commissions and fees	28,230	27,731	30,981
Other charges, commissions and fees	28,105	23,125	22,877
Net gain (loss) on securities transactions	(1)	19	(3,377)
Other	43,828	42,400	33,304
Total non-interest income	240,747	230,379	225,110
Non-interest expense:			
Salaries and wages	190,784	166,059	158,039
Employee benefits	46,231	41,577	40,176
Net occupancy	34,695	31,107	29,375
Furniture and equipment	26,293	23,912	22,771
Intangible amortization	5,628	4,859	5,346
Other	106,722	99,493	89,323
Total non-interest expense	410,353	367,007	345,030
Income before income taxes	285,407	244,388	209,018
Income taxes	91,816	78,965	67,693
Net income	$193,591	$165,423	$141,325
Earnings per common share:			
Basic	$ 3.49	$ 3.15	$ 2.74
Diluted	3.42	3.07	2.66

See accompanying Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.
Consolidated Balance Sheets
(Dollars in thousands, except per share amounts)

	December 31, 2006	December 31, 2005
Assets:		
Cash and due from banks	$ 707,683	$ 873,015
Interest-bearing deposits	1,677	6,438
Federal funds sold and resell agreements	735,225	1,033,975
Total cash and cash equivalents	1,444,585	1,913,428
Securities held to maturity, at amortized cost	10,096	12,701
Securities available for sale, at estimated fair value	3,330,953	3,059,111
Trading account securities	9,406	6,217
Loans, net of unearned discounts	7,373,384	6,085,055
Less: Allowance for possible loan losses	(96,085)	(80,325)
Net loans	7,277,299	6,004,730
Premises and equipment, net	219,533	182,356
Goodwill	524,117	168,983
Other intangible assets, net	38,480	14,903
Cash surrender value of life insurance policies	111,742	102,604
Accrued interest receivable and other assets	257,978	276,404
Total assets	$13,224,189	$11,741,437
Liabilities:		
Deposits:		
Non-interest-bearing demand deposits	$ 3,699,701	$ 3,484,932
Interest-bearing deposits	6,688,208	5,661,462
Total deposits	10,387,909	9,146,394
Federal funds purchased and repurchase agreements	864,190	740,529
Subordinated notes payable and other borrowings	186,366	188,617
Junior subordinated deferrable interest debentures	242,270	226,805
Accrued interest payable and other liabilities	166,571	456,856
Total liabilities	11,847,306	10,759,201
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; 59,839,144 shares issued in 2006 and 54,961,616 shares issued in 2005	598	550
Additional paid-in capital	548,117	279,627
Retained earnings	883,060	776,193
Accumulated other comprehensive loss, net of tax	(54,892)	(50,442)
Treasury stock, no shares in 2006 and 478,881 shares in 2005, at cost	—	(23,692)
Total shareholders' equity	1,376,883	982,236
Total liabilities and shareholders' equity	$13,224,189	$11,741,437

See accompanying Notes to Consolidated Financial Statements.

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

	Year Ended December 31,		
	2006	2005	2004
Operating Activities:			
Net income	$ 193,591	$ 165,423	$ 141,325
Adjustments to reconcile net income to net cash from operating activities:			
Provision for possible loan losses	14,150	10,250	2,500
Deferred tax expense (benefit)	(1,266)	555	5,319
Accretion of loan discounts	(10,824)	(10,124)	(6,102)
Securities premium amortization (discount accretion), net	(1,516)	329	1,815
Net (gain) loss on securities transactions	1	(19)	3,377
Depreciation and amortization	25,169	24,357	24,482
Origination of loans held for sale, net of principal collected	(66,443)	(60,839)	(61,035)
Proceeds from sales of loans held for sale	73,248	76,431	58,139
Net gain on sale of loans held for sale and other assets	(2,149)	(3,418)	(2,274)
Stock-based compensation	9,240	1,986	1,377
Tax benefits from stock-based compensation	113	11,371	11,524
Excess tax benefits from stock-based compensation	(16,243)	—	—
Net proceeds from settlement of legal claims	—	(2,389)	—
Earnings on life insurance policies	(4,123)	(3,934)	(4,128)
Net change in:			
Trading account securities	(3,189)	(1,546)	918
Accrued interest receivable and other assets	22,308	(52,150)	(30,480)
Accrued interest payable and other liabilities	(285,202)	(23,847)	(17,976)
Net cash from operating activities	(53,135)	132,436	128,781
Investing Activities:			
Securities held to maturity:			
Maturities, calls and principal repayments	2,596	4,004	8,466
Securities available for sale:			
Purchases	(14,070,071)	(10,763,788)	(8,518,256)
Sales	26,912	19,812	597,369
Maturities, calls and principal repayments	13,977,742	10,944,589	7,873,115
Net change in loans	(180,517)	(605,415)	(581,043)
Net cash paid in acquisitions	(100,074)	(13,297)	(7,063)
Proceeds from sales of premises and equipment	208	465	276
Purchases of premises and equipment	(27,494)	(18,098)	(15,398)
Benefits received on life insurance policies	—	6,553	4,883
Proceeds from sales of repossessed properties	1,750	3,457	4,247
Net cash from investing activities	(368,948)	(421,718)	(633,404)
Financing Activities:			
Net change in deposits	(113,996)	721,655	36,821
Net change in short-term borrowings	105,607	234,187	84,541
Principal payments on notes payable and other borrowings	(19,251)	(6,255)	(1,880)
Proceeds from junior subordinated deferrable interest debentures	—	—	123,712
Proceeds from stock option exercises	42,703	35,805	36,006
Excess tax benefits from stock-based compensation	16,243	—	—
Purchase of treasury stock	(4,666)	(14,972)	(65,212)
Cash dividends paid	(73,400)	(61,499)	(53,782)
Net cash from financing activities	(46,760)	908,921	160,206
Net change in cash and cash equivalents	(468,843)	619,639	(344,417)
Cash and cash equivalents at beginning of year	1,913,428	1,293,789	1,638,206
Cash and cash equivalents at end of year	$ 1,444,585	$ 1,913,428	$ 1,293,789

See accompanying Notes to Consolidated Financial Statements

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

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Treasury Stock	Total
Balance at January 1, 2004	$536	$197,073	$625,405	$ 8,063	$(61,073)	$ 770,004
Comprehensive income:						
Net income	—	—	141,325	—	—	141,325
Other comprehensive loss, net of tax	—	—	—	(18,847)	—	(18,847)
Total comprehensive income						122,478
Stock option exercises (1,547,650 shares)	—	—	(15,076)	—	51,082	36,006
Tax benefit from stock-based compensation		11,524	—	—	—	11,524
Purchase of treasury stock (1,466,991 shares)	—	—	—	—	(65,212)	(65,212)
Non-vested stock awards (67,100 shares)		(2,631)	—	—	2,631	—
Stock-based compensation expense recognized in earnings		1,377	—	—	—	1,377
Cash dividends ($1.035 per share)	—	—	(53,782)	—	—	(53,782)
Balance at December 31, 2004	536	207,343	697,872	(10,784)	(72,572)	822,395
Comprehensive income:						
Net income	—	—	165,423	—	—	165,423
Other comprehensive loss, net of tax	—	—	—	(39,658)	—	(39,658)
Total comprehensive income						125,765
Stock issued in acquisition of Horizon Capital Bank (1,400,000 shares)	14	61,371	—	—	—	61,385
Stock option exercises (1,419,195 shares)	—		(25,603)	—	61,408	35,805
Tax benefit from stock-based compensation	—	11,371	—	—	—	11,371
Purchase of treasury stock (312,412 shares)	—	—	—	—	(14,972)	(14,972)
Non-vested stock awards (52,100 shares)	—	(2,455)	—	—	2,455	—
Stock-based compensation expense recognized in earnings	—	1,997	—	—	(11)	1,986
Cash dividends ($1.165 per share)	—	—	(61,499)	—	—	(61,499)
Balance at December 31, 2005	550	279,627	776,193	(50,442)	(23,692)	982,236
Comprehensive income:						
Net income	—	—	193,591	—	—	193,591
Other comprehensive loss, net of tax	—	—	—	(4,450)	—	(4,450)
Total comprehensive income						189,141
Stock issued in acquisition of Summit Bancshares (3,818,934 shares)	38	215,235	—	—	—	215,273
Stock option exercises (1,572,230 shares)	10	28,695	(13,324)	—	27,322	42,703
Tax benefits from stock-based compensation	—	113	—	—	—	113
Excess tax benefits from stock-based compensation	—	16,243	—	—	—	16,243
Purchase of treasury stock (86,855 shares)	—	—	—	—	(4,666)	(4,666)
Non-vested stock awards (52,100 shares)	—	(1,036)	—	—	1,036	—
Stock-based compensation expense recognized in earnings	—	9,240	—	—	—	9,240
Cash dividends ($1.32 per share)	—	—	(73,400)	—	—	(73,400)
Balance at December 31, 2006	$598	$548,117	$883,060	$(54,892)	$ —	$1,376,883

See accompanying Notes to Consolidated Financial Statements

Note 1 — Summary of 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. In addition to general commercial and consumer banking, other products and services offered include trust and investment management, investment banking, insurance brokerage, leasing, asset-based lending, treasury management and item processing.

Basis of Presentation. The consolidated financial statements 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.

The Corporation determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity under accounting principles generally accepted in the United States. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make decisions about the entity's activities. The Corporation consolidates voting interest entities in which it has all, or at least a majority of, the voting interest. As defined in applicable accounting standards, variable interest entities (VIEs) are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in an entity is present when an enterprise has a variable interest, or a combination of variable interests, that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE. The Corporation's wholly owned subsidiaries, Cullen/Frost Capital Trust I, Cullen/Frost Capital Trust II, Alamo Corporation of Texas Trust I and Summit Bancshares Statutory Trust I are VIEs for which the Corporation is not the primary beneficiary. Accordingly, the accounts of these entities are not included in the Corporation's consolidated financial statements.

Certain items in prior financial statements have been reclassified to conform to the current presentation. All acquisitions during the reported periods were accounted for using the purchase method. Accordingly, the operating results of the acquired companies are included with the Corporation's results of operations since their respective dates of acquisition (see Note 2 — Mergers and Acquisitions).

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 values of financial instruments, and the status of contingencies are particularly subject to change.

Cash Flow Reporting. Cash and cash equivalents include cash, deposits with other financial institutions that have an initial maturity of less than 90 days when acquired by the Corporation, federal funds sold and resell agreements. Net cash flows are reported for loans, loans held for sale, deposit transactions and short-term borrowings.

Cash paid for interest totaled $211.3 million in 2006, $109.5 million in 2005 and $60.0 million in 2004. Cash paid for income taxes totaled $75.6 million in 2006, $61.3 million in 2005 and $53.5 million in 2004. Significant non-cash transactions included $327.7 million of unsettled securities purchases in 2005, $215.3 million and $61.4 million of common stock issued in connection with the acquisitions in 2006 and 2005, transfers of loans to other real estate owned and foreclosed assets in connection with loan foreclosures of $2.2 million in 2006, $460 thousand in 2005 and $8.0 million in 2004.

Concentrations and Restrictions on Cash and Cash Equivalents. The Corporation maintains deposits with other financial institutions in amounts that exceed federal deposit insurance coverage. Furthermore, federal funds sold are essentially uncollateralized loans to other financial institutions. Management regularly evaluates the credit risk associated with the counterparties to these transactions and believes that the Corporation is not exposed to any significant credit risks on cash and cash equivalents.

The Corporation was required to have $85.9 million and $77.6 million of cash on hand or on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at December 31, 2006 and 2005. Deposits with the Federal Reserve Bank do not earn interest.

Repurchase/Resell Agreements. The Corporation purchases certain securities under agreements to resell. The amounts advanced under these agreements represent short-term loans and are reflected as assets in the accompanying consolidated balance sheets. The securities underlying these agreements are book-entry securities. The Corporation also sells certain securities under agreements to repurchase. The agreements are treated as collateralized financing transactions and the obligations to repurchase securities sold are reflected as a liability in the accompanying consolidated balance sheets. The dollar amount of the securities underlying the agreements remain in the asset accounts.

Securities. Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them until maturity. Securities to be held for indefinite periods of time are classified as available for sale and carried at fair value, with the unrealized holding gains and losses reported as a component of other comprehensive income, net of tax. Securities held for resale in anticipation of short-term market movements are classified as trading and are carried at fair value, with changes in unrealized holding gains and losses included in income. Management determines the appropriate classification of securities at the time of purchase. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost.

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

Loans. Loans are reported at the principal balance outstanding net of unearned discounts. Interest income on loans is reported on the level-yield method and includes amortization of deferred loan fees and costs over the loan term. Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period. Income on direct financing leases is recognized on a basis that achieves a constant periodic rate of return on the outstanding investment.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. 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.

Loans Acquired Through Transfer. Loans acquired through the completion of a transfer, including loans acquired in a business combination, that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Corporation will be unable to collect all contractually required payment receivable are initially recorded at fair value (as determined by the present value of expected future cash flows) with no valuation allowance. The difference between the undiscounted cash flows expected at acquisition and the investment in the loan, or the "accretable yield," is recognized as interest income on a level-yield method over the life of the loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the "nonaccretable difference," are not recognized as a yield adjustment or as a loss accrual or a valuation allowance. Increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows are recognized as impairment. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition (meaning the present value of all cash flows expected at acquisition that ultimately are not to be received).

Loans Held for Sale. The Corporation originates student loans primarily for sale in the secondary market. Accordingly, student loans are classified as held for sale and are carried at the lower of cost or fair value, determined on an aggregate basis. Student loans are generally sold on a non-recourse basis after the deferment period has ended; however, from time to time, the Corporation may sell such loans prior to the end of the deferment period. Gains or losses recognized upon the sale of loans are determined on a specific identification basis. Student loans totaled \$47.3 million and \$51.2 million at December 31, 2006 and 2005 and are included in total loans in the consolidated balance sheets.

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 inherent in the loan portfolio. The allowance for possible loan losses includes allowance allocations calculated in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114, "Accounting by Creditors for Impairment of a Loan," as amended by SFAS 118, and allowance allocations calculated in accordance with SFAS 5, "Accounting for Contingencies." 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.

The Corporation's allowance for possible loan losses consists of three elements: (i) specific valuation allowances established for probable losses on specific loans; (ii) historical valuation allowances calculated based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) unallocated general valuation allowances determined based on general economic conditions and other qualitative risk factors both internal and external to the Corporation.

Premises and Equipment. Land is carried at cost. Building and improvements, and furniture and equipment are carried at cost, less accumulated depreciation, computed principally by the straight-line method based on the estimated useful lives of the related property. Leasehold improvements are generally depreciated over the lesser of the term of the respective leases or the estimated useful lives of the improvements.

Foreclosed Assets. Assets acquired through or instead of loan foreclosure are held for sale and are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. Costs after acquisition are generally expensed. If the fair value of the asset declines, a write-down is recorded through expense. The valuation of foreclosed assets is subjective in nature and may be adjusted in the future because of changes in economic conditions or review by regulatory examiners. Foreclosed assets are included in other assets in the accompanying consolidated balance sheets and totaled \$5.5 million and \$5.7 million at December 31, 2006 and 2005.

Goodwill. Goodwill represents the excess of the cost of businesses acquired over the fair value of the net assets acquired. Prior to 2002, goodwill was amortized over its estimated life using the straight-line method or an accelerated basis (as appropriate) over periods generally not exceeding 25 years. On January 1, 2002, in accordance with a new accounting standard, the Corporation stopped amortizing goodwill and adopted a new policy for measuring goodwill for impairment. Under the new policy, goodwill is assigned to reporting units. Goodwill is then tested for impairment at least annually, or on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying value. See Note 7 — Goodwill and Other Intangible Assets.

Intangibles and Other Long-Lived Assets. Intangible assets are acquired assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. The Corporation's intangible assets relate to core deposits, non-compete agreements and customer relationships. Intangible assets with definite useful lives are amortized on an accelerated basis over their estimated life. Intangible assets with indefinite useful lives are not amortized until their lives are determined to be definite. Intangible assets, premises and equipment and other long-lived assets are tested for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value. See Note 7 — Goodwill and Other Intangible Assets.

Insurance Commissions and Fees. Commission revenue is recognized as of the effective date of the insurance policy or the date the customer is billed, whichever is later. The Corporation also receives contingent commissions from insurance companies as additional incentive for achieving specified premium volume goals and/or the loss experience of the insurance placed by the Corporation. Contingent commissions from insurance companies are recognized when determinable, which is generally when such commissions are received or when the Corporation receives data from the insurance companies that allows the reasonable estimation of these amounts. The Corporation maintains a reserve for commission adjustments based on estimated policy cancellations. This reserve was not significant at December 31, 2006 or 2005.

Stock-Based Compensation. Prior to January 1, 2006, employee compensation expense under stock option plans was reported only if options were granted below market price at grant date in accordance with the intrinsic value method of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Because the exercise price of the Corporation's employee stock options always equaled the market price of the underlying stock on the date of grant, no compensation expense was recognized on options granted. The Corporation adopted the provisions of SFAS No. 123, "Share-Based Payment (Revised 2004)," on January 1, 2006. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which, for the Corporation, is the date of the grant. The Corporation transitioned to fair-value based accounting for stock-based compensation using a modified version of prospective application ("modified prospective application"). Under modified prospective application, as it is applicable to the Corporation, SFAS 123R applies to new awards and to awards modified, repurchased, or cancelled after January 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (generally referring to non-vested awards) that were outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered during the period of and/or the periods after the adoption of SFAS 123R. The attribution of compensation cost for those earlier awards is based on the same method and on the same grant-date fair values previously determined for the pro forma disclosures required for companies that did not previously adopt the fair value accounting method for stock-based employee compensation. Compensation expense for non-vested stock awards is based on the fair value of the awards, which is generally the market price of the stock on the measurement date, which, for the Corporation, is the date of grant, and is recognized ratably over the service period of the award.

SFAS No. 123R, requires pro forma disclosures of net income and earnings per share for all periods prior to the adoption of the fair value accounting method for stock-based employee compensation. The pro forma disclosures presented in Note 13 — Employee Benefit Plans use the fair value method of SFAS 123 to measure compensation expense for stock-based employee compensation plans for years prior to 2006.

Advertising Costs. Advertising costs are expensed as incurred.

Income Taxes. Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities (excluding deferred tax assets and liabilities related to business combinations or components of other comprehensive income). Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Although realization is not assured, management believes it is more likely than not that all of the deferred tax assets will be realized.

The Corporation files a consolidated income tax return with its subsidiaries. Federal income tax expense or benefit has been allocated to subsidiaries on a separate return basis.

Basic and Diluted Earnings Per Common Share. Basic earnings per common share is based on net income divided by the weighted-average number of common shares outstanding during the period excluding non-vested stock. Diluted earnings per common share include the dilutive effect of stock options and non-vested stock awards granted using the treasury stock method. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 11 — Shareholders' Equity and Earnings Per Common Share.

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 is reported in the accompanying consolidated statements of changes in shareholders' equity.

Derivative Financial Instruments. The Corporation's hedging policies permit the use of various derivative financial instruments to manage interest rate risk or to hedge specified assets and liabilities. All derivatives are recorded at fair value on the Corporation's balance sheet. To qualify for hedge accounting, derivatives must be highly effective at reducing the risk associated with the exposure being hedged and must be designated as a hedge at the inception of the derivative contract. The Corporation considers a hedge to be highly effective if the change in fair value of the derivative hedging instrument is within 80% to 125% of the opposite change in the fair value of the hedged item attributable to the hedged risk. If derivative instruments are designated as hedges of fair values, and such hedges are highly effective, both the change in the fair value of the hedge and the hedged item are included in current earnings. Fair value adjustments related to cash flow hedges are recorded in other comprehensive income and are reclassified to earnings when the hedged transaction is reflected in earnings. Ineffective portions of hedges are reflected in earnings as they occur. Actual cash receipts and/or payments and related accruals on derivatives related to hedges are recorded as adjustments to the interest income or interest expense associated with the hedged item. During the life of the hedge, the Corporation formally assesses whether derivatives designated as hedging instruments continue to be highly effective in offsetting changes in the fair value or cash flows of hedged items. If it is determined that a hedge has ceased to be highly effective, the Corporation will discontinue hedge accounting prospectively. At such time, previous adjustments to the carrying value of the hedged item are reversed into current earnings and the derivative instrument is reclassified to a trading position recorded at fair value.

The Corporation may be required to recognize certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative.

Fair Values of Financial Instruments. Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on- and off-balance sheet financial instruments do not include the value of anticipated future business or the value of assets and liabilities not considered financial instruments.

Transfers of Financial Assets. Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the assets have been isolated from the Corporation, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Loss Contingencies. Loss contingencies, including claims and legal actions arising in the ordinary course of business are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

Trust Assets. Assets of the Corporation's trust department, other than cash on deposit at Frost Bank, are not included in the accompanying financial statements because they are not assets of the Corporation.

Note 2 — Mergers and Acquisitions

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

Texas Community Bancshares, Inc. On February 9, 2006, the Corporation acquired Texas Community Bancshares, Inc. including its subsidiary, Texas Community Bank and Trust, N.A. ("TCB"), a privately-held bank holding company and bank located in Dallas, Texas. The Corporation purchased all of the outstanding shares of TCB for approximately $32.1 million. The purchase price includes $31.1 million in cash and approximately $1.0 million in acquisition-related costs. Upon completion of the acquisition, TCB was fully integrated into Cullen/Frost and Frost Bank. As of December 31, 2006, the Corporation had a liability totaling $2.3 million related to TCB shares that have not yet been tendered for payment.

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

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

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

	TCB	Alamo	Summit
Cash and cash equivalents	$ 27,595	$ 27,281	$ 110,674
Securities available for sale	15,842	52,499	146,448
Loans, net	64,376	222,887	814,191
Premises and equipment, net	427	10,554	14,994
Core deposit intangible asset	3,355	6,381	20,374
Goodwill	20,126	59,377	275,914
Other assets	3,664	5,506	7,928
Deposits	(101,298)	(280,285)	(973,928)
Other borrowings	—	(11,012)	(39,507)
Other liabilities	(1,992)	(5,203)	(6,952)
	$ 32,095	$ 87,985	$ 370,136

The core deposit intangible assets acquired in these transactions will be amortized using an accelerated method over a period of 10 years. Additional information related to intangible assets and goodwill is included in Note 7 — Goodwill and Other Intangible Assets. Pro forma condensed consolidated results of operations assuming TCB, Alamo and Summit had been acquired at the beginning of the reported periods are not presented because the combined effect of these acquisitions was not considered significant for financial reporting purposes.

Horizon Capital Bank. On October 7, 2005, the Corporation acquired Horizon Capital Bank ("Horizon"), a privately-held bank headquartered in Houston, Texas. The Corporation purchased all of the outstanding shares of Horizon for approximately $109.3 million. The total purchase price includes $61.4 million of the Corporation's common stock (1.4 million shares), $46.9 million in cash and approximately $1.0 million in acquisition-related costs. Upon completion of the acquisition, Horizon was fully integrated into Frost Bank.

The total purchase price paid for the acquisition was allocated based on the estimated fair values of the assets acquired and liabilities assumed as set forth below.

Cash and cash equivalents	$ 33,559
Securities available for sale	26,963
Loans, net	323,099
Premises and equipment, net	9,201
Core deposit intangible asset	4,856
Goodwill	68,296
Other assets	8,677
Deposits	(319,061)
Other borrowings	(44,000)
Other liabilities	(2,338)
	$ 109,252

The core deposit intangible assets acquired in this transaction will be amortized using an accelerated method over a period of 10 years. Additional information related to intangible assets and goodwill is included in Note 7 — Goodwill and Other Intangible Assets.

The Sammons Group. During the third quarter of 2004, the Corporation acquired The Sammons Group, a full-service, independent insurance agency based in Dallas, Texas. The acquired company, which offered commercial property and casualty insurance, as well as personal lines, life insurance and group employee benefit plans, was fully integrated into Frost Insurance Agency. In connection with the acquisition, the Corporation recorded customer relationship intangibles totaling $2.1 million, intangibles related to non-compete agreements totaling $1.4 million, and goodwill totaling $3.5 million.

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

Year-end securities held to maturity and available for sale consisted of the following:

	December 31, 2006				December 31, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity								
U.S. government agencies and corporations	$ 9,096	$ 87	$ 14	$ 9,169	$ 11,701	$ 126	$ 25	$ 11,802
Other	1,000	—	11	989	1,000	—	12	988
Total	$ 10,096	$ 87	$ 25	$ 10,158	$ 12,701	$ 126	$ 37	$ 12,790
Available for Sale								
U.S. Treasury	$ 89,954	$ 1	$ 272	$ 89,683	$ 84,897	$ —	$ 588	$ 84,309
U.S. government agencies and corporations	2,946,212	5,507	49,110	2,902,609	2,710,445	6,632	40,974	2,676,103
States and political subdivisions	309,002	2,672	1,298	310,376	268,975	3,741	1,423	271,293
Other	28,285	—	—	28,285	27,406	—	—	27,406
Total	$3,373,453	$8,180	$50,680	$3,330,953	$3,091,723	$10,373	$42,985	$3,059,111

Securities with a carrying value totaling $2.1 billion at both December 31, 2006 and 2005 were pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law.

Year-end securities with unrealized losses, segregated by length of impairment, were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
December 31, 2006						
Held to Maturity						
U.S. government agencies and corporations	$ 732	$ 1	$ 2,869	$ 13	$ 3,601	$ 14
Other	—	—	989	11	989	11
Total	$ 732	$ 1	$ 3,858	$ 24	$ 4,590	$ 25
Available for Sale						
U.S. Treasury	$ —	$ —	$ 84,708	$ 272	$ 84,708	$ 272
U.S. government agencies and corporations	764,803	3,009	1,593,831	46,101	2,358,634	49,110
States and political subdivisions	61,791	528	34,728	770	96,519	1,298
Total	$ 826,594	$ 3,537	$1,713,267	$47,143	$2,539,861	$50,680

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
December 31, 2005						
Held to Maturity						
U.S. government agencies and corporations	$ 4,539	$ 20	$ 280	$ 5	$ 4,819	$ 25
Other	988	12	—	—	988	12
Total	$ 5,527	$ 32	$ 280	$ 5	$ 5,807	$ 37
Available for Sale						
U.S. Treasury	$ 84,309	$ 588	$ —	$ —	$ 84,309	$ 588
U.S. government agencies and corporations	$1,086,601	$14,469	$ 786,339	$26,505	$1,872,940	$40,974
States and political subdivisions	72,361	916	14,070	507	86,431	1,423
Total	$1,243,271	$15,973	$ 800,409	$27,012	$2,043,680	$42,985

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

Management has the ability and intent to hold the securities classified as held to maturity until they mature, at which time the Corporation will receive full value for the securities. Furthermore, as of December 31, 2006, management also had 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 December 31, 2006, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Corporation's consolidated income statement.

The amortized cost and estimated fair value of securities at December 31, 2006 are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities, collateralized mortgage obligations and equity securities are shown separately since they are not due at a single maturity date.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$ —	$ —	$ 214,375	$ 214,118
Due after one year through five years	1,000	989	105,381	105,909
Due after five years through ten years	—	—	117,997	118,763
Due after ten years	—	—	89,858	89,789
Mortgage-backed securities and collateralized mortgage obligations	9,096	9,169	2,817,557	2,774,089
Equity securities	—	—	28,285	28,285
Total	$10,096	$10,158	$3,373,453	$3,330,953

Sales of securities available for sale were as follows:

	2006	2005	2004
Proceeds from sales	$26,912	$19,812	$597,369
Gross realized gains	117	19	513
Gross realized losses	118	—	3,890

Note 4 — Trading Account Securities

Year-end trading account securities, at estimated fair value, were as follows:

	2006	2005
U.S. Treasury	$8,515	$6,217
States and political subdivisions	891	—
	$9,406	$6,217

The net gain on trading account securities, which includes amounts realized from sale transactions and mark-to-market adjustments, totaled $2.1 million in 2006, $1.9 million in 2005 and $1.8 million in 2004.

Note 5 — Loans

Year-end loans consisted of the following:

	2006	2005
Commercial and industrial:		
Commercial	$3,229,570	$2,610,178
Leases	174,075	148,750
Asset-based	33,856	41,288
Total commercial and industrial	3,437,501	2,800,216
Real estate:		
Construction:		
Commercial	649,140	590,635
Consumer	114,142	87,746
Land:		
Commercial	407,055	301,907
Consumer	5,394	10,369
Commercial mortgages	1,766,469	1,409,811
1-4 family residential mortgages	125,294	95,032
Home equity and other consumer	508,574	460,941
Total real estate	3,576,068	2,956,441
Consumer:		
Indirect	3,475	2,418
Student loans held for sale	47,335	51,189
Other	310,752	265,038
Other	27,703	27,201
Unearned discounts	(29,450)	(17,448)
Total loans	$7,373,384	$6,085,055

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 December 31, 2006 and 2005, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

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

Foreign Loans. The Corporation has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at December 31, 2006 or 2005.

Related Party Loans. In the ordinary course of business, the Corporation has granted loans to certain directors, executive officers and their affiliates (collectively referred to as "related parties") totaling $2.5 million at December 31, 2006 and $3.2 million at December 31, 2005. These loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other unaffiliated persons and do not involve more than normal risk of collectibility. During 2006, total principal additions were $6.2 million and total principal reductions were $6.9 million, including $6.0 million in principal repayments and $928 thousand due to changes in related party status.

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 $52.2 million at December 31, 2006 and $33.2 million at December 31, 2005. Had non-accrual loans performed in accordance with their original contract terms, the Corporation would have recognized additional interest income of approximately $2.9 million in 2006, $2.4 million in 2005 and $2.2 million in 2004. Accruing loans past due more than 90 days totaled $10.9 million at December 31, 2006 and $7.9 million at December 31, 2005. There were no restructured loans outstanding during 2006 or 2005.

Impaired Loans. Year-end impaired loans were as follows:

	2006	2005
Balance of impaired loans with no allocated allowance	$ 5,933	$ 8,491
Balance of impaired loans with an allocated allowance	38,254	17,520
Total recorded investment in impaired loans	$44,187	$26,011
Amount of the allowance allocated to impaired loans	$ 8,729	$ 8,811

The impaired loans included in the table above were primarily comprised of collateral dependent commercial loans. The average recorded investment in impaired loans was $29.2 million in 2006, $27.5 million in 2005 and $36.3 million in 2004. No interest income was recognized on these loans subsequent to their classification as impaired.

Loans Acquired Through Transfer. Approximately $4.7 million of loans acquired in the acquisition of Summit had evidence of deterioration of credit quality since origination and it was probable that all contractually required payments receivable would not be collected on these loans. These loans were recorded at their fair value of $3.2 million with no associated allowance for loan losses in accordance with American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer." Additional disclosures required by SOP 03-3 are not provided because the amounts are not significant.

Allowance for Possible Loan Losses. Activity in the allowance for possible loan losses was as follows:

	2006	2005	2004
Balance at the beginning of the year	$ 80,325	$ 75,810	$ 83,501
Provision for possible loan losses	14,150	10,250	2,500
Allowance for possible loan losses acquired	12,720	3,186	—
Net charge-offs:			
Losses charged to the allowance	(18,933)	(15,105)	(20,015)
Recoveries of loans previously charged off	7,823	6,184	9,824
Net charge-offs	(11,110)	(8,921)	(10,191)
Balance at the end of the year	$ 96,085	$ 80,325	$ 75,810

Note 6 — Premises and Equipment

Year-end premises and equipment were as follows:

	2006	2005
Land	$ 61,835	$ 56,182
Buildings	151,203	136,594
Furniture and equipment	152,561	133,515
Leasehold improvements	49,316	49,511
Construction in progress	12,932	872
	427,847	376,674
Less accumulated depreciation and amortization	(208,314)	(194,318)
Total premises and equipment, net	$ 219,533	$ 182,356

Depreciation and amortization of premises and equipment totaled $16.3 million in 2006, $14.4 million in 2005 and $13.8 million in 2004.

Note 7 — Goodwill and Other Intangible Assets

Goodwill. Goodwill totaled $524.1 million at December 31, 2006 and $169.0 million at December 31, 2005. During 2006, the Corporation recorded goodwill totaling $355.4 million in connection with the acquisitions of TCB, Alamo and Summit. During 2005, the Corporation recorded goodwill totaling $68.6 million in connection with the acquisition of Horizon. During 2006, this goodwill was reduced $283 thousand as a result of a reallocation of the purchase price based on additional information related to the valuation of certain assets acquired and liabilities assumed. During the second quarter of 2005, the Corporation wrote-off goodwill totaling $2.0 million in connection with the settlement of legal claims against certain former employees of Frost Insurance Agency. The Corporation recorded goodwill totaling $3.5 million in 2004 in connection with insurance agency acquisitions. See Note 2 — Mergers and Acquisitions.

Other Intangible Assets. Other intangible assets were as follows:

	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets
December 31, 2006			
Core deposits	$66,253	$(30,475)	$35,778
Customer relationships	3,914	(2,026)	1,888
Non-compete agreements	1,793	(979)	814
	$71,960	$(33,480)	$38,480
December 31, 2005			
Core deposits	$52,551	$(41,436)	$11,115
Customer relationships	3,914	(1,475)	2,439
Non-compete agreements	3,310	(1,961)	1,349
	$59,775	$(44,872)	$14,903

During 2006, the Corporation recorded core deposit intangibles totaling $30.1 million in connection with the acquisitions of TCB, Alamo and Summit. During the fourth quarter of 2005, the Corporation recorded a core deposit intangible totaling $5.8 million in connection with the acquisition of Horizon. During 2006, the core deposit intangible recorded in connection with the acquisition of Horizon was reduced $905 thousand based upon a final determination of its value. See Note 2 — Mergers and Acquisitions. During the second quarter of 2005, the Corporation wrote-off certain customer relationship intangibles totaling $147 thousand in connection with the settlement of legal claims against certain former employees of Frost Insurance Agency.

Other intangible assets are amortized on an accelerated basis over their estimated lives, which range from 5 to 10 years. Amortization expense related to intangible assets totaled $5.6 million in 2006, $4.9 million in 2005 and $5.3 million in 2004. The estimated aggregate future amortization expense for intangible assets remaining as of December 31, 2006 is as follows:

2007	$ 8,829
2008	7,268
2009	5,734
2010	4,483
2011	3,737
Thereafter	8,429
	$38,480

Note 8 — Deposits

Year-end deposits were as follows:

	2006	2005
Non-interest-bearing demand deposits:		
Commercial and individual	$ 3,384,232	$2,945,366
Correspondent banks	237,463	458,821
Public funds	78,006	80,745
Total non-interest-bearing demand deposits	3,699,701	3,484,932
Interest-bearing deposits:		
Private accounts:		
Savings and interest checking	1,470,792	1,320,781
Money market accounts	3,393,961	2,761,944
Time accounts under $100,000	612,466	431,741
Time accounts of $100,000 or more	791,699	534,151
Public funds	419,290	612,845
Total interest-bearing deposits	6,688,208	5,661,462
Total deposits	$10,387,909	$9,146,394

At December 31, 2006 and 2005, interest-bearing public funds deposits included $127.0 million and $314.3 million in savings and interest checking accounts, $97.8 million and $84.4 million in money market accounts, $6.6 million and $6.1 million in time accounts under $100 thousand, and $187.9 million and $208.0 million in time accounts of $100 thousand or more, respectively.

The Corporation had approximately $64.1 million and $44.1 million of non-interest-bearing demand deposits at December 31, 2006 and 2005 that were received under a contractual relationship assumed in connection with the acquisition of Horizon. Deposits from foreign sources, primarily Mexico, totaled $711.0 million and $641.2 million at December 31, 2006 and 2005. Deposits from certain directors, executive officers and their affiliates totaled $41.9 million and $49.4 million at December 31, 2006 and 2005.

Scheduled maturities of time deposits, including both private and public funds, at December 31, 2006 were as follows:

2007	$1,358,650
2008	190,613
2009	34,389
2010	14,397
2011	679
Thereafter	—
	$1,598,728

Scheduled maturities of time deposits in amounts of $100,000 or more, including both private and public funds, at December 31, 2006, were as follows:

Due within 3 months or less	$392,449
Due after 3 months and within 6 months	231,662
Due after 6 months and within 12 months	259,550
Due after 12 months	95,967
	$979,628

Note 9 — Borrowed Funds

Line of Credit. Cullen/Frost has available a $25 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 December 31, 2006 or 2005.

Federal Home Loan Bank Advances. Federal Home Loan Bank (FHLB) advances totaled $36.4 million and $38.6 million at December 31, 2006 and 2005. The advances mature at varying dates through 2013 and had a weighted-average rate of 4.38% and 4.00% at December 31, 2006 and 2005. The advances are collateralized by a blanket floating lien on all first mortgage loans, certain pledged securities, the FHLB capital stock owned by the Corporation and any funds on deposit with the FHLB.

Scheduled minimum future principal payments on Federal Home Loan Bank advances at December 31, 2006 were as follows:

2007	$25,220
2008	4,569
2009	16
2010	6,517
2011	19
Thereafter	25
	$36,366

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase. Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Federal funds purchased totaled $45.5 million and $30.2 million at December 31, 2006 and 2005. Securities sold under agreements to repurchase are secured short-term borrowings that typically mature within thirty to ninety days. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. The Corporation may be required to provide additional collateral based on the fair value of the underlying securities. Securities sold under agreements to repurchase totaled $818.7 million and $710.3 million at December 31, 2006 and 2005.

Subordinated Notes Payable. In August 2001, Frost Bank issued $150 million of subordinated notes that mature in 2011 and bear interest at 6.875%, per annum, which is payable semi-annually. The notes, which are not redeemable prior to maturity, qualify as Tier 2 capital for both Frost Bank and Cullen/Frost. Proceeds from the sale of the notes were used for general corporate purposes. The principal balance of the notes was $150.0 million at December 31, 2006 and 2005, while unamortized debt issuance costs, which are included in other assets, totaled $621 thousand and $756 thousand at those dates.

Junior Subordinated Deferrable Interest Debentures. The Corporation has issued a total of $242.3 million of junior subordinated deferrable interest debentures to four wholly owned Delaware statutory business trusts, Cullen/Frost Capital Trust I ("Trust I"), Cullen/Frost Capital Trust II ("Trust II"), Alamo Corporation of Texas Trust I ("Alamo Trust") and Summit Bancshares Statutory Trust I ("Summit Trust"). The trusts are considered variable interest entities for which the Corporation is not the primary beneficiary. Accordingly, the accounts of the trusts are not included in the Corporation's consolidated financial statements. See Note 1 — Summary of Significant Accounting Policies for additional information about the Corporation's consolidation policy. Details of the Corporation's transactions with these trusts are presented below.

In February 1997, Trust I issued $100 million of 8.42% trust preferred securities, which represent preferred beneficial interests in the assets of the trust. The trust preferred securities will mature on February 1, 2027, and are redeemable with the approval of the Federal Reserve Board in whole or in part at the option of the Corporation at any time after February 1, 2007, and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions on the trust preferred securities are payable semi-annually in arrears on February 1 and August 1 of each year. Trust I also issued $3.1 million of common equity securities to Cullen/Frost. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase $103.1 million of 8.42% junior subordinated deferrable interest debentures issued by the Corporation, which have terms substantially similar to the trust preferred securities.

In February 2004, Trust II issued $120 million of floating rate (three-month LIBOR plus a margin of 1.55%) trust preferred securities, which represent beneficial interests in the assets of the trust. The trust preferred securities will mature on March 1, 2034 and are redeemable with the approval of the Federal Reserve Board in whole or in part at the option of the Corporation at any time after March 1, 2009 and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions on the trust preferred securities are payable quarterly in arrears on March 1, June 1, September 1 and December 1 of each year. Trust II also issued $3.7 million of common equity securities to Cullen/Frost. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase $123.7 million of floating rate (three-month LIBOR plus a margin of 1.55%, which was equal to 6.94% and 5.96% at December 31, 2006 and 2005) junior subordinated deferrable interest debentures issued by the Corporation, which have terms substantially similar to the trust preferred securities.

Alamo Trust is a Delaware statutory trust formed in 2002 for the purpose of issuing $3.0 million in trust preferred securities. Alamo Trust was acquired by Cullen/Frost through the acquisition of Alamo on February 28, 2006. The trust preferred securities will mature on January 7, 2033 and are redeemable with the approval of the Federal Reserve Board in whole or in part at the option of the Corporation at any time after January 7, 2008 and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions on the trust preferred securities are payable quarterly in arrears on January 7, April 7, July 7, and October 7 of each year. Alamo Trust also issued $93 thousand of common equity securities to Alamo. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase $3.1 million of floating rate (three-month LIBOR plus a margin of 3.30%, which was equal to 8.67% at December 31, 2006) junior subordinated deferrable interest debentures issued by Alamo, which have terms substantially similar to the trust preferred securities.

Summit Trust is a Delaware statutory trust formed in 2004 for the purpose of issuing $12.0 million in trust preferred securities. Summit Trust was acquired by Cullen/Frost through the acquisition of Summit Bancshares on December 8, 2006. The trust preferred securities will mature on July 7, 2034 and are redeemable with the approval of the Federal Reserve Board in whole or in part at the option of the Corporation at any time after July 7, 2009 and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions on the trust preferred securities are payable quarterly in arrears on January 7, April 7, July 7 and October 7 of each year. Summit Trust also issued $372 thousand of common equity securities to Summit. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase $12.4 million of floating rate (three-month LIBOR plus a margin of 2.65%, which was equal to 8.02% at December 31, 2006) junior subordinated deferrable interest debentures issued by Summit, which have terms substantially similar to the trust preferred securities.

The Corporation has the right to defer payments of interest on the debentures at any time or from time to time for a period of up to ten consecutive semi-annual periods with respect to each deferral period in the case of the debentures issued to Trust I, and a period of up to twenty consecutive quarterly periods with respect to each deferral period in the case of the debentures issued to Trust II, Alamo Trust and Summit Trust. Under the terms of the debentures, in the event that under certain circumstances there is an event of default under the debentures or the Corporation has elected to defer interest on the debentures, the Corporation may not, with certain exceptions, declare or pay any dividends or distributions on its capital stock or purchase or acquire any of its capital stock.

Payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities are guaranteed by the Corporation on a limited basis. The Corporation also entered into or assumed agreements with the trusts as to expenses and liabilities pursuant to which the Corporation has agreed, on a subordinated basis, to pay any costs, expenses or liabilities of each trust other than those arising under the trust preferred securities. The obligations of the Corporation under the junior subordinated debentures, the related indentures, the trust agreements establishing the trusts, the guarantees and the agreements as to expenses and liabilities, in the aggregate, constitute a full and unconditional guarantee by the Corporation of each trust's obligations under the trust preferred securities.

Despite the fact that the accounts of Trust I, Trust II, Alamo Trust and Summit Trust are not included in the Corporation's consolidated financial statements, the $235 million in trust preferred securities issued by these subsidiary trusts are included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes as allowed by the Federal Reserve Board. In February 2005, the Federal Reserve Board issued a final rule that allows the continued inclusion of trust preferred securities in the Tier 1 capital of bank holding companies. The Board's final rule limits the aggregate amount of restricted core capital elements (which includes trust preferred securities, among other things) that may be included in the Tier 1 capital of most bank holding companies to 25% of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Large, internationally active bank holding companies (as defined) are subject to a 15% limitation. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The final rule provides a five-year transition period, ending March 31, 2009, for application of the quantitative limits. The Corporation does not expect that the quantitative limits will preclude it from including the $235 million in trust preferred securities in Tier 1 capital. However, the trust preferred securities could be redeemed without penalty if they were no longer permitted to be included in Tier 1 capital.

Note 10 — Off-Balance-Sheet Arrangements, Commitments, Guarantees 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.

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 $4.0 billion and $3.3 billion at December 31, 2006 and 2005.

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 $254.8 million and $241.6 million at December 31, 2006 and 2005.

The Corporation considers the fees collected in connection with the issuance of standby letters of credit to be representative of the fair value of its obligation undertaken in issuing the guarantee. In accordance with applicable accounting standards related to guarantees, the Corporation defers fees collected in connection with the issuance of standby letters of credit. The fees are then recognized in income proportionately over the life of the standby letter of credit agreement. At December 31, 2006 and 2005, the Corporation had deferred standby letter of credit fees totaling $1.2 million and $1.3 million, which represent the fair value of the Corporation's potential obligations under the standby letter of credit guarantees.

Credit Card Guarantees. The Corporation guarantees the credit card debt of certain customers to the merchant bank that issues the cards. At December 31, 2006 and 2005, the guarantees totaled $10.4 million and $9.5 million, of which amounts, $5.5 million and $5.9 million were fully collateralized.

Securities Lending. The Corporation lends certain customer securities to creditworthy brokers on behalf of those customers. If the borrower fails to return these securities, the Corporation indemnifies its customers based on the fair value of the securities. The Corporation holds collateral received in securities lending transactions as an agent. Accordingly, such collateral assets are not assets of the Corporation. The Corporation requires borrowers to provide collateral equal to or in excess of 100% of the fair value of the securities borrowed. The collateral is valued daily and additional collateral is requested as necessary. The maximum future payments guaranteed by the

Corporation under these contractual agreements (representing the fair value of securities lent to brokers) totaled \$2.1 billion at December 31, 2006. At December 31, 2006, the Corporation held liquid assets with a fair value of \$2.2 billion as collateral for these agreements.

Lease Commitments. The Corporation leases certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled \$16.2 million in 2006, \$13.1 million in 2005 and \$13.1 million in 2004. Future minimum lease payments due under non-cancelable operating leases at December 31, 2006 were as follows:

2007	\$15,175
2008	14,676
2009	12,275
2010	9,153
2011	7,279
Thereafter	31,545
	\$90,103

It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire. Aggregate future minimum rentals to be received under non-cancelable subleases greater than one year at December 31, 2006, were \$2.0 million.

The Corporation leases a branch facility from a partnership interest of a director. Payments related to this lease totaled \$810 thousand in 2006, \$758 thousand in 2005 and \$823 thousand in 2004. The terms of the lease are substantially the same as those offered for comparable transactions with non-related parties at the time the lease transaction was consummated.

Change in Control Agreements. The Corporation has change-in-control agreements with certain executive officers. Under these agreements, each covered person could receive, upon the effectiveness of a change-in-control, two to three times (depending on the person) his or her base compensation plus the target bonus established for the year, and any unpaid base salary and pro rata target bonus for the year in which the termination occurs, including vacation pay. Additionally, the executive's insurance benefits will continue for two to three full years after the termination and all long-term incentive awards will immediately vest.

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 11 — Shareholders' Equity and Earnings Per Common Share

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

	2006	2005	2004
Weighted-average shares outstanding for basic earnings per share	55,467	52,481	51,651
Dilutive effect of stock options and non-vested stock awards	1,175	1,322	1,489
Weighted-average shares outstanding for diluted earnings per share	56,642	53,803	53,140

Stock Purchase Rights. Under a shareholder protection rights agreement established in 1999, every share of common stock carries the right (a "Right"), under certain circumstances, to purchase a unit of one one-hundredth of a share of junior participating preferred stock at a price of \$100.00 per unit. The Rights, which expire on February 8, 2009, will only become exercisable upon distribution. Distribution of the rights will not occur until ten days after the earlier of (i) the commencement of, or announcement of an intention to make, a tender offer or exchange offer that would result in a person or group, with certain exclusions, acquiring the beneficial ownership of 10.0% or more of the Corporation's outstanding common stock, or (ii) the public announcement that a person or group has acquired beneficial ownership of 10.0% or more of the Corporation's outstanding common stock.

The purchase price payable, and the number of units of preferred stock issuable, upon exercise of the Rights are subject to adjustment from time to time to prevent dilution in the event of a stock dividend, among other things. The Corporation may redeem the Rights in whole, but not in part, at a price of $0.01 per Right at the sole discretion of the Corporation's Board of Directors at any time prior to distribution of the Rights. The Corporation's Board of Directors may amend the terms of the Rights without the consent of the holders of the Rights, except that after the distribution of the Rights, no amendment may be made that would materially adversely affect the interests of the holders of the Rights. Until a Right is exercised, the holder of a Right will have no rights as a stockholder of the Corporation, including, without limitation, the right to vote or to receive dividends.

Stock Repurchase Plans. The Corporation has maintained several stock repurchase plans authorized by the Corporation's board of directors. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. Under the most recent plan, which expired on April 29, 2006, the Corporation was authorized to repurchase up to 2.1 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, during 2005, the Corporation repurchased 300 thousand shares at a cost of $14.4 million, all of which occurred during the first quarter. No shares were repurchased during 2006. Over the life of the plan, the Corporation repurchased a total of 833.2 thousand shares at a cost of $39.9 million.

Note 12 — Regulatory Matters

Capital. 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 $235 million of trust preferred securities issued by Trust I, Trust II, Alamo Trust and Summit Trust (see Note 9 — Borrowed Funds). Cullen/Frost's and Frost Bank's total capital is comprised of Tier 1 capital for each entity plus $150 million of 6.875% subordinated notes payable and a permissible portion of the allowance for possible loan losses.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average 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
December 31, 2006						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$1,332,744	13.43%	$793,889	8.00%	N/A	N/A
Frost Bank	1,234,583	12.45	793,555	8.00	$991,944	10.00%
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,116,659	11.25	396,944	4.00	N/A	N/A
Frost Bank	1,018,498	10.27	396,778	4.00	595,166	6.00
Leverage Ratio						
Cullen/Frost	1,116,659	9.56	467,275	4.00	N/A	N/A
Frost Bank	1,018,498	8.73	466,835	4.00	583,543	5.00
December 31, 2005						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$1,273,702	14.94%	$682,154	8.00%	N/A	N/A
Frost Bank	991,846	11.64	681,703	8.00	$852,129	10.00%
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,043,377	12.24	341,077	4.00	N/A	N/A
Frost Bank	761,521	8.94	340,852	4.00	511,277	6.00
Leverage Ratio						
Cullen/Frost	1,043,377	9.62	433,819	4.00	N/A	N/A
Frost Bank	761,521	7.03	433,269	4.00	541,586	5.00

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

Dividend Restrictions. In the ordinary course of business, Cullen/Frost is dependent upon dividends from Frost Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of Frost Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years. At December 31, 2006, Frost Bank could pay dividends of up to $180.6 million to Cullen/Frost without prior regulatory approval and without adversely affecting its "well capitalized" status.

Note 13 — Employee Benefit Plans

Retirement Plans

Profit Sharing Plans. On January 1, 2002, the Corporation adopted a profit-sharing plan that replaced its defined benefit plan. The profit-sharing plan is a defined contribution retirement plan that covers employees who have completed at least one year of service and are age 21 or older. All contributions to the plan are made at the discretion of the Corporation based upon the fiscal year profitability. Contributions are allocated to eligible participants pro rata, based upon compensation, age and other factors. Plan participants self-direct the investment of allocated contributions by choosing from a menu of investment options. Account assets are subject to withdrawal restrictions and participants vest in their accounts after three years of service. Expense related to this plan totaled $8.7 million in 2006, $8.8 million in 2005 and $8.1 million in 2004.

The Corporation maintains a separate non-qualified profit sharing plan for certain employees whose participation in the qualified profit sharing plan is limited. The plan offers such employees an alternative means of receiving comparable benefits. Expense related to this plan totaled $393 thousand in 2006, $439 thousand in 2005 and $491 thousand in 2004.

Retirement Plan and Restoration Plan. The Corporation maintains a non-contributory defined benefit plan (the "Retirement Plan") that was frozen as of December 31, 2001. The plan provides pension and death benefits to substantially all employees who were at least 21 years of age and had completed at least one year of service prior to December 31, 2001. Defined benefits are provided based on an employee's final average compensation and years of service at the time the plan was frozen and age at retirement. The freezing of the plan provides that future salary increases will not be considered. The Corporation's funding policy is to contribute yearly, at least the amount necessary to satisfy the funding standards of the Employee Retirement Income Security Act ("ERISA"). In the ordinary course of business, Frost Bank acts as agent for the plan in securities lending transactions in which the plan lends certain of its securities to third parties.

The Corporation's Restoration of Retirement Income Plan (the "Restoration Plan") provides benefits for eligible employees that are in excess of the limits under Section 415 of the Internal Revenue Code of 1986, as amended, that apply to the Retirement Plan. The Restoration Plan is designed to comply with the requirements of ERISA. The entire cost of the plan, which was also frozen as of December 31, 2001, is supported by contributions from the Corporation.

The Corporation uses a December 31 measurement date for its defined benefit plans. Combined activity in the Corporation's defined benefit pension plans was as follows:

	2006	2005	2004
Change in benefit obligation:			
Benefit obligation at beginning of year	$126,766	$114,630	$108,436
Interest cost	7,180	6,766	6,658
Actuarial (gain) loss	(134)	9,189	3,255
Benefits paid	(3,949)	(3,819)	(3,719)
Benefit obligation at end of year	129,863	126,766	114,630
Change in plan assets:			
Fair value of plan assets at beginning of year	83,204	77,143	70,608
Actual return on plan assets	8,023	4,440	4,624
Employer contributions	4,458	5,440	5,630
Benefits paid	(3,949)	(3,819)	(3,719)
Fair value of plan assets at end of year	91,736	83,204	77,143
Funded status of the plan at end of year	38,127	43,562	37,487
Unrecognized net actuarial loss	—	(44,560)	(34,947)
Accrued benefit (asset) liability recognized	$ 38,127	$ (998)	$ 2,540
Accumulated benefit obligation at end of year	$129,863	$126,766	$114,630

Certain disaggregated information related to the Corporation's defined benefit pension plans as of year-end was as follows:

	Retirement Plan		Restoration Plan	
	2006	2005	2006	2005
Projected benefit obligation	$115,187	$112,928	$14,676	$13,838
Accumulated benefit obligation	115,187	112,928	14,676	13,838
Fair value of plan assets	91,736	83,204	—	—

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

	2006	2005	2004
Expected return on plan assets, net of expenses	$(7,454)	$(7,008)	$(6,321)
Interest cost on projected benefit obligation	7,180	6,766	6,658
Net amortization and deferral	2,997	2,146	1,865
Net periodic benefit cost	$ 2,723	$ 1,904	$ 2,202

Amounts related to the Corporation's defined benefit pension plans recognized as a component of other comprehensive income were as follows:

	2006	2005	2004
Net actuarial gain (loss)	$ 3,701	$(9,613)	$(3,064)
Deferred tax (expense) benefit	(1,295)	3,365	1,072
Other comprehensive income (loss), net of tax	$ 2,406	$(6,248)	$(1,992)

Amounts recognized as a component of accumulated other comprehensive loss as of year-end that have not been recognized as a component of the combined net period benefit cost of the Corporation's defined benefit pension plans are presented in the following table. The Corporation expects to recognize approximately $2.7 million of the net actuarial loss reported in the following table as of December 31, 2006 as a component of net periodic benefit cost during 2007.

	2006	2005
Net actuarial loss	$(40,859)	$(44,560)
Deferred tax benefit	14,301	15,596
Amounts included in accumulated other comprehensive loss, net of tax	$(26,558)	$(28,964)

The weighted-average assumptions used to determine the benefit obligations as of the end of the years indicated and the net periodic benefit cost for the years indicated are presented in the table below. Because the plans were frozen, increases in compensation are not considered after 2001.

	2006	2005	2004
Benefit obligations:			
Discount rate	5.85%	5.75%	6.00%
Net periodic benefit cost:			
Discount rate	5.75%	6.00%	6.25%
Expected return on plan assets	8.75	8.75	8.75

The asset allocation of the Corporation's Retirement Plan as of year-end is presented in the following table. The Corporation's Restoration Plan is unfunded.

	2006	2005
Equity securities	73.7%	71.4%
Debt securities (fixed income)	20.8	25.4
Cash and cash equivalents	5.5	3.2
Total	100.0%	100.0%

Management uses an asset allocation optimization model to analyze the potential risks and rewards associated with various asset allocation strategies on a quarterly basis. As of December 31, 2006, management's investment objective for the Corporation's defined benefit plans is to achieve long-term growth. This strategy provides for a target asset mix of approximately 70% invested in equity securities, approximately 30% invested in fixed income debt securities with any remainder invested in cash or short-term cash equivalents. The modeling process calculates, with a 90% confidence ratio, the potential risk associated with a given asset allocation and helps achieve adequate diversification of investment assets. The plan assets are reviewed annually to determine if the obligations can be met with the current investment mix and funding strategy.

The asset allocation optimization model is used to estimate the expected long-term rate of return for a given asset allocation strategy. During periods with volatile interest rates and equity security prices, the model may call for changes in the allocation of plan investments to achieve desired returns. Management assumed a long-term rate of return of 8.75% in the determination of the net periodic benefit cost for 2006. This assumption is supported by a 15 year historical annualized return for a quarterly rebalanced portfolio with allocation targets of: (i) 65% equity securities (invested in the Wilshire 5000 equity index), (ii) 30% fixed income debt securities (invested in the Lehman Brothers bond index) and (iii) 5% cash equivalents. The expected long-term rate of return for this investment strategy is reduced by 70 basis points for trustee and investment expenses and administrative fees.

The Corporation's investment strategies prohibit selling assets short and the use of derivatives. Additionally, the Corporation's defined benefit plans do not invest in real estate, commodities, or private investments. The plans may lend certain securities to creditworthy brokers. The brokers must provide collateral equal to or in excess of 100% of the fair value of the securities borrowed.

As of December 31, 2006, expected future benefit payments related to the Corporation's defined benefit plans were as follows:

2007	$ 4,176
2008	4,967
2009	5,401
2010	5,762
2011	6,530
2012 through 2016	38,061
	$64,897

The Corporation expects to contribute $4.5 million to the defined benefit plans during 2007.

Supplemental Executive Retirement Plan. The Corporation maintains a supplemental executive retirement plan ("SERP") for one active key executive. The plan provides for target retirement benefits, as a percentage of pay, beginning at age 55. The target percentage is 45 percent of pay at age 55, increasing to 60 percent at age 60 and later. Benefits under the SERP are reduced, dollar-for-dollar, by benefits received under the profit sharing, non-qualified profit sharing, defined benefit retirement and restoration plans, described above, and any social security benefits.

Post-Retirement Healthcare Benefits. The Corporation provides post-retirement healthcare benefits to certain former employees. The related unfunded benefit obligations totaled $973 thousand and $3.6 million at December 31, 2006 and 2005. Of these amounts, $973 thousand and $2.0 million had been recognized in the Corporation's consolidated balance sheets at December 31, 2006 and 2005. The net periodic benefit cost totaled $420 thousand in 2006, $394 thousand in 2005, and $309 thousand in 2004. The Corporation's share of benefits paid under the plan totaled $1.2 million in 2006 and $594 thousand in 2005. The discount rates used to determine the benefit obligations were 5.85% and 5.75% at December 31, 2006 and 2005. The discount rates used to determine the net periodic benefit cost was 5.75% for 2006, 6.00% for 2005 and 6.25% for 2004. The assumed health care cost trend rate for 2007 is 8.00%; however, the ultimate trend rate is expected to be 5.00%, which is expected to be achieved by 2010. The estimated effect of a one percent increase or a one percent decrease in the assumed healthcare cost trend rate would not significantly impact the service cost and interest cost components of the net periodic benefit cost or the accumulated post-retirement benefit obligation. The Corporation's contributions related to post-retirement health care benefits are expected to be $258 thousand in 2007. Future benefit payments are expected to be less than $300 thousand in 2007 with a diminishing annual amount through 2016.

Amounts related to the Corporation's post-retirement healthcare benefit plan recognized in other comprehensive income during 2006 totaled $661 thousand, or $429 thousand net of tax expense of $232 thousand. No amounts related to the Corporation's post-retirement healthcare benefit plan were recognized in other comprehensive income during 2005 or 2004. Amounts related to the Corporation's post-retirement healthcare benefit plan included in accumulated other comprehensive income at December 31, 2006 totaled $429 thousand, ($661 thousand net of tax of $232 thousand), of which amount, the Corporation expects to recognize approximately $103 thousand as a component of net periodic benefit cost during 2007.

Savings Plans

401(k) Plan and Thrift Incentive Plan. The Corporation maintains a 401(k) stock purchase plan that permits each participant to make before- or after-tax contributions in an amount not less than 2% and not exceeding 20% of eligible compensation and subject to dollar limits from Internal Revenue Service regulations. The Corporation matches 100% of the employee's contributions to the plan based on the amount of each participant's contributions up to a maximum of 6% of eligible compensation. Eligible employees must complete 90 days of service in order to enroll and vest in the Corporation's matching contributions immediately. Expense related to the plan totaled $7.7 million in 2006, $6.3 million in 2005 and $5.9 million in 2004. The Corporation's matching contribution is initially invested in Cullen/Frost common stock. However, employees may immediately reallocate the Corporation's matching portion, as well as invest their individual contribution, to any of a variety of investment alternatives offered under the 401(k) Plan.

The Corporation maintains a thrift incentive stock purchase plan to offer certain employees whose participation in the 401(k) plan is limited an alternative means of receiving comparable benefits. Expense related to this plan totaled $72 thousand in 2006, $63 thousand in 2005 and $60 thousand in 2004.

Stock Compensation Plans

The Corporation has three active executive stock plans (the 1992 Stock Plan, the 2001 Stock Plan and the 2005 Omnibus Incentive Plan) and one active outside director stock plan (the 1997 Director Stock Plan). The executive stock plans were established to help the Corporation retain and motivate key employees, while the outside director stock plan was established as a means to compensate outside directors for their service to the Corporation. All of the plans have been approved by the Corporation's shareholders. The Compensation and Benefits Committee ("Committee") of the Corporation's Board of Directors has sole authority to select the employees, establish the awards to be issued, and approve the terms and conditions of each award contract under the executive stock plans.

The 2001 Stock Plan superceded the 1992 Stock Plan and all remaining shares authorized for grant under the superceded 1992 Stock Plan were transferred to the 2001 Stock Plan. During 2005, the 2005 Omnibus Incentive Plan ("2005 Plan") was established to replace all other previously approved executive stock plans and the remaining shares authorized for grant under the 2001 plan were cancelled. Under the 2005 Plan, the Corporation may grant, among other things, nonqualified stock options, incentive stock options, stock awards, stock appreciation rights, or any combination thereof to certain employees.

The 1997 Director Stock Plan allows the Corporation to grant nonqualified stock options to outside directors. The options may be awarded in such number, and upon such terms, and at any time and from time to time as determined by the Committee.

Options awarded under the 1997 Directors Plan during the periods presented have a six-year life with immediate vesting. Options awarded prior to 2001 under the 1997 Directors Plan have a ten-year life with immediate vesting. Options related to other plans awarded since 1999 have a six-year life with a three-year-cliff vesting period. Options awarded in 1998 have a ten-year life with a three-year-cliff vesting period. In general, options awarded prior to 1998 have a ten-year life with a five-year vesting period. Beginning in October 2005, options awarded under the 2005 Plan have a ten-year life and vest in equal annual installments over a four-year period. Non-vested stock awards are generally awarded with a four-year cliff vesting period.

Each award from all plans is evidenced by an award agreement that specifies the option price, the duration of the option, the number of shares to which the option pertains, and such other provisions as the Committee determines. The option price for each grant is at least equal to the fair market value of a share of Cullen/Frost's common stock on the date of grant. Options granted expire at such time as the Committee determines at the date of grant and in no event does the exercise period exceed a maximum of ten years. Upon a change-in-control of Cullen/Frost, as defined in the plans, all outstanding options immediately vest.

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

		Non-Vested Stock Awards Outstanding		Stock Options Outstanding	
	Shares Available for Grant	Number of Shares	Weighted-Average Grant-Date Fair Value	Number of Shares	Weighted-Average Exercise Price
Balance, January 1, 2004	1,920,573	131,103	$35.84	6,897,900	$26.97
Granted	(783,200)	67,100	47.29	716,100	47.16
Stock options exercised	—	—	—	(1,547,650)	23.26
Stock awards vested	—	(1,223)	37.72	—	—
Forfeited	22,400	—	—	(22,400)	31.77
Canceled	—	—	—	—	—
Balance, December 31, 2004	1,159,773	196,980	39.73	6,043,950	30.29
Shares authorized — 2005 Plan	4,000,000	—	—	—	—
Granted	(906,100)	52,100	50.01	854,000	49.68
Stock options exercised	—	—	—	(1,419,500)	23.03
Stock awards vested	—	(2,223)	33.25	—	—
Forfeited	84,005	(305)	35.95	(83,700)	27.10
Canceled	(1,131,278)	—	—	—	—
Balance, December 31, 2005	3,206,400	246,552	41.97	5,394,750	34.61
Granted	(889,400)	52,100	57.88	837,300	57.68
Stock options exercised	—	—		(1,572,230)	27.16
Stock awards vested	—	(61,546)	33.46	—	—
Forfeited	115,931	(1,306)	38.30	(114,625)	47.51
Canceled	(46,906)	—	—	—	—
Balance, December 31, 2006	2,386,025	235,800	47.72	4,545,195	41.19

Other information regarding options outstanding and exercisable as of December 31, 2006 is as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Number of Shares	Weighted-Average Exercise Price
\$20.00 - \$25.00	981,070	\$24.10	1.12	981,070	\$24.10
25.01 - 30.00	140,000	26.89	1.82	140,000	26.89
30.01 - 35.00	417,000	32.96	2.07	417,000	32.96
35.01 - 40.00	714,900	37.93	2.53	714,900	37.93
40.01 - 45.00	35,000	42.76	3.52	30,000	43.08
45.01 - 50.00	691,700	47.33	3.88	37,500	46.22
50.01 - 55.00	729,725	50.03	8.78	187,900	50.03
55.01 - 60.00	835,800	57.68	9.72	20,000	56.90
Total	4,545,195	41.19	4.70	2,528,370	32.37

Proceeds from stock option exercises totaled \$42.7 million in 2006, \$35.8 million in 2005 and \$36.0 million in 2004. Shares issued in connection with stock option exercises are issued from available treasury shares. If no treasury shares are available, new shares are issued from available authorized shares. During 2006, 1,006,494 shares issued in connection with stock option exercises were new shares issued from available authorized shares, while 565,736 shares were issued from available treasury stock. During the 2005 and 2004, all shares issued in connection with stock option exercises and non-vested stock awards were issued from available treasury stock.

The total intrinsic value of outstanding stock options and outstanding exercisable stock options was \$68.1 million and \$59.3 million at December 31, 2006. The total intrinsic value of stock options exercised was \$45.6 million in 2006, \$32.5 million in 2005 and \$32.9 million in 2004. The total fair value of share awards vested was \$3.3 million during 2006, \$114 thousand in 2005 and \$53 thousand in 2004.

Stock-based Compensation Expense. As stated in Note 1 — Significant Accounting Policies, the Corporation adopted the provisions of SFAS 123R on January 1, 2006. SFAS 123R requires that stock-based compensation to employees be recognized as compensation cost in the income statement based on their fair values on the measurement date, which, for the Corporation, is the date of the grant. As a result of applying the provisions of SFAS 123R during 2006, the Corporation recognized additional stock-based compensation expense related to stock options of \$6.6 million, or \$4.3 million net of tax. The increase in stock-based compensation expense related to stock options, resulted in a \$0.08 decrease in both basic and diluted earnings per share during 2006. Cash flows from financing activities for 2006 included \$16.2 million in cash inflows from excess tax benefits related to stock compensation. Such cash flows were previously reported as operating activities.

Stock-based compensation expense totaled \$9.2 million in 2006, \$2.0 million in 2005 and \$1.4 million in 2004. Stock-based compensation expense is recognized ratably over the requisite service period for all awards. The total income tax benefit recognized in the accompanying consolidated statements of income related to stock-based compensation was \$3.2 million in 2006, \$695 thousand in 2005 and \$482 thousand in 2004. Unrecognized stock-based compensation expense related to stock options totaled \$16.7 million at December 31, 2006. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 2.6 years. Unrecognized stock-based compensation expense related to non-vested stock awards was \$6.5 million at December 31, 2006. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 2.2 years.

Valuation of Stock-Based Compensation. The fair value of the Corporation's employee stock options granted is estimated on the measurement date, which, for the Corporation, is the date of grant. Prior to the fourth quarter of 2006, the fair value of stock options was estimated using the Black-Scholes option-pricing model. The weighted-average fair value of stock options granted was \$12.69 for options granted prior to the fourth quarter of 2006, \$11.09 for 2005 and \$10.72 for 2004. The Corporation estimated expected market price volatility and expected term of the options based on historical data and other factors. The weighted-average assumptions used to determine the fair value of options granted prior to the fourth quarter of 2006 are detailed in the table below:

	2006	2005	2004
Risk-free interest rate	4.93%	4.20%	3.35%
Dividend yield	2.49%	2.53%	2.25%
Expected market price volatility	23.0%	23.0%	27.0%
Expected term	5.1 Years	6.1 Years	5.0 Years

During the fourth quarter of 2006, the Corporation changed its methodology for estimating the fair value of stock options granted from the Black-Scholes option-pricing model to a binomial lattice-based valuation model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of publicly traded options that have no vesting restrictions and are fully transferable. The Corporation's employee stock options have characteristics that are significantly different from those of publicly traded options in that the Corporation's stock options are not transferable and are frequently exercised well in advance of expiration. Additionally, the Black-Scholes option-pricing model does not allow for the use of dynamic assumptions about interest rates, expected volatility and expected dividends, among other things. Because of the limitations of the Black-Scholes options-pricing model, SFAS 123R indicates that the use of a more complex binomial lattice-based valuation model that takes into account employee exercise patterns based on changes in the Corporation's stock price and other variables, and allows for the use of other dynamic assumptions, may result in a better valuation of employee stock options. Accordingly, management concluded that the use of a binomial lattice-based model provides fair value estimates that better achieve the fair value measurement objective of SFAS 123R. As a result of the change to a binomial lattice-based model, the amount of stock-based compensation expense the Corporation expects to recognize over the requisite service period of the stock options granted during the fourth quarter of 2006 is approximately $1.7 million less than what would have otherwise been recognized had the Corporation continued to use the Black-Scholes option-pricing model.

The weighted-average fair value of stock options granted during the fourth quarter of 2006, estimated using a binomial lattice-based valuation model, was $11.97. The assumptions used to determine the fair value of options granted during the fourth quarter of 2006 are detailed in the table below.

Risk-free interest rate	0.43% to 11.84%
Weighted-average risk-free interest rate	4.71%
Dividend yield	2.50%
Expected market price volatility	15.3% to 27.9%
Weighted-average expected market price volatility	25.7%
Expected term	5.2 to 7.0 Years
Weighted-average expected term	5.6 Years

Expected volatility is based on the short-term historical volatility (estimated over the most recent two years) and the long-term historical volatility (estimated over a period at least equal to the contractual term of the options) of the Corporation's stock, and other factors. A variance targeting methodology is utilized to estimate the convergence, or mean reversion, from short-term to long-term volatility within the model. In estimating the fair value of stock options under the binomial lattice-based valuation model, separate groups of employees that have similar historical exercise behavior are considered separately. The expected term of options granted is derived using a regression model and represents the period of time that options granted are expected to be outstanding. The range of expected term results from certain groups of employees exhibiting different behavior.

The fair value of non-vested stock awards for the purposes of recognizing stock-based compensation expense is the market price of the stock on the measurement date, which, for the Corporation, is the date of the award.

Pro Forma Net Income and Earnings Per Common Share. The following pro forma information presents net income and earnings per share for 2005 and 2004 as if the fair value method of SFAS 123 had been used to measure compensation cost for stock-based compensation plans. For purposes of these pro forma disclosures, the estimated fair value of stock options and stock awards is amortized to expense over the related vesting periods.

	2005	2004
Net income, as reported	$165,423	$141,325
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	1,291	895
Less: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(5,296)	(5,586)
Pro forma net income	$161,418	$136,634
Earnings per common share:		
Basic — as reported	$ 3.15	$ 2.74
Basic — pro forma	3.08	2.65
Diluted — as reported	3.07	2.66
Diluted — pro forma	3.00	2.57

Note 14 — Other Non-Interest Income and Expense

Other non-interest income and expense totals are presented in the following tables. Components of these totals exceeding 1% of the aggregate of total net interest income and total non-interest income for any of the years presented are stated separately.

	2006	2005	2004
Other non-interest income:			
Check card income	$ 12,095	$ 9,401	$ 7,398
Other	31,733	32,999	25,906
Total	$ 43,828	$42,400	$33,304
Other non-interest expense:			
Legal and other professional fees	$ 17,180	$12,102	$ 9,653
Advertising, promotions and public relations	10,982	11,293	9,619
Stationary, printing and supplies	7,195	6,143	5,566
Outside computer services	4,030	10,310	10,370
Other	67,335	59,645	54,115
Total	$106,722	$99,493	$89,323

Note 15 — Income Taxes

Income tax expense was as follows:

	2006	2005	2004
Current income tax expense	$93,082	$78,410	$62,374
Deferred income tax expense (benefit)	(1,266)	555	5,319
Income tax expense	$91,816	$78,965	$67,693

Reported income tax expense differed from the amounts computed by applying the U.S. federal statutory income tax rate of 35% to income before income taxes as follows:

	2006	2005	2004
Income tax expense computed at the statutory rate	$99,892	$85,536	$73,156
Effect of tax-exempt interest	(6,482)	(4,986)	(3,680)
Bank owned life insurance income	(1,443)	(1,377)	(1,445)
Other	(151)	(208)	(338)
Income tax expense, as reported	$91,816	$78,965	$67,693

Year-end deferred taxes were as follows:

	2006	2005
Deferred tax assets:		
Allowance for possible loan losses	$ 32,339	$ 27,701
Building modification reserve	1,268	1,387
Gain on sale of assets	2,899	2,995
Net unfunded liability for defined benefit post-retirement benefit plans	14,069	15,596
Net unrealized loss on securities available for sale and effective cash flow hedging derivatives	15,488	11,564
Reserve for medical insurance	2,436	2,804
Dollar-roll repurchase agreements	1,440	1,920
Other	8,620	4,521
Total gross deferred tax assets	78,559	68,488
Deferred tax liabilities:		
Prepaid expenses	(1,227)	(1,182)
Intangible assets	(14,018)	(3,953)
Federal Home Loan Bank stock dividends	(1,069)	(967)
Retirement plan	(2,143)	(1,525)
Premises and equipment	(2,964)	(1,784)
Other	(2,769)	(1,644)
Total gross deferred tax liabilities	(24,190)	(11,055)
Net deferred tax asset	$ 54,369	$ 57,433

No valuation allowance for deferred tax assets was recorded at December 31, 2006 and 2005 as management believes it is more likely than not that all of the deferred tax assets will be realized because they were supported by recoverable taxes paid in prior years.

Note 16 — Other Comprehensive Income

Total comprehensive income is reported in the accompanying statements of changes in shareholders' equity. Information related to net other comprehensive income (loss) is as follows:

	2006	2005	2004
Other comprehensive income (loss):			
Securities available for sale:			
Change in net unrealized gain/loss during the period	$(9,888)	$(50,951)	$(29,307)
Reclassification adjustment for (gains) losses included in income	1	(19)	3,377
Change in funded status of defined benefit post-retirement benefit plans	4,362	(9,613)	(3,064)
Change in accumulated gain/loss on effective cash flow hedging derivatives	(1,322)	(430)	—
	(6,847)	(61,013)	(28,994)
Deferred tax benefit	2,397	21,355	10,147
Net other comprehensive loss	$(4,450)	$(39,658)	$(18,847)

The components of accumulated other comprehensive income, net of tax, as of year-end were as follows:

	2006	2005
Net unfunded liability for defined benefit post-retirement benefit plans	$(26,129)	$(28,964)
Net unrealized gain (loss) on securities available for sale	(27,625)	(21,198)
Accumulated loss on effective cash flow hedging derivatives	(1,138)	(280)
	$(54,892)	$(50,442)

Note 17 — 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 Corporation utilizes interest rate swaps, caps and floors to mitigate exposure to interest rate risk. Many of the Corporation's interest rate derivative positions are matched to specific fixed-rate commercial loans or leases that the Corporation has entered into with its customers. These derivative positions have been designated as hedging instruments to hedge the risk of changes in the fair value of the underlying commercial loan/lease due to changes in interest rates. The related contracts are structured so that the notional amounts reduce over time to generally match the expected amortization of the underlying loan/lease.

The Corporation also has three interest rate floor contracts with a total notional amount of $1.3 billion. The interest rate floor 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 $1.3 billion of variable-rate loans outstanding throughout the 36-month period beginning on December 15, 2005 and ending on December 15, 2008 from the risk of a decrease in those cash flows to a level such that the yield on the underlying loans would be less than a range of 6.00% to 7.00%, depending upon the applicable floor contract.

The Corporation also has certain interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which the Corporation enters into an interest rate swap, cap and/or floor with a customer while at the same time entering into an offsetting interest rate swap, cap and/or floor with another financial institution. In connection with each swap transaction, the Corporation agrees to pay interest to the customer on a notional amount at a variable interest rate and receive interest from the customer on a similar notional amount at a fixed interest rate. At the same time, the Corporation agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the Corporation's customer to effectively convert a variable rate loan to a fixed rate. Because the Corporation acts as an intermediary for its customer, changes in the fair value of the underlying derivative contracts offset each other and do not impact the Corporation's results of operations.

The notional amounts and estimated fair values of interest rate derivative positions outstanding at year-end are presented in the following table. The estimated fair values of the subordinated debt interest rate swap and the interest rate floors on variable-rate loans are based on a quoted market price. Internal present value models are used to estimate the fair values of the other interest rate swaps, caps and floors.

	2006		2005	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate derivatives designated as hedges of fair value:				
Commercial loan/lease interest rate swaps	$ 15,337	$ 182	$ 163,068	$ 1,513
Commercial loan/lease interest rate caps	—	—	4,810	41
Interest rate swaps related to subordinated notes	—	—	300,000	450
Interest rate derivatives designated as hedges of cash flows:				
Interest rate floors on variable-rate loans	1,300,000	366	1,300,000	1,702
Non-hedging interest rate derivatives:				
Commercial loan/lease interest rate swaps	200,910	3,320	138,546	2,409
Commercial loan/lease interest rate swaps	200,910	(3,320)	138,546	(2,409)
Commercial loan/lease interest rate caps	17,500	5	19,375	24
Commercial loan/lease interest rate caps	17,500	(5)	19,375	(24)
Commercial loan/lease interest rate floors	17,500	8	19,375	53
Commercial loan/lease interest rate floors	17,500	(8)	19,375	(53)

The weighted-average receive and pay interest rates for interest rate swaps and the weighted-average strike rates for interest rate caps and floors outstanding at December 31, 2006 were as follows:

	Weighted-Average		
	Interest Rate Paid	Interest Rate Received	Strike Rate
Interest rate swaps:			
Commercial loan/lease interest rate swaps	4.68%	5.35%	—
Non-hedging interest rate swaps	5.56	5.56	—
Interest rate caps and floors:			
Interest rate floors on variable-rate loans	—	—	6.00%
Non-hedging commercial loan/lease interest rate caps	—	—	6.00
Non-hedging commercial loan/lease interest rate floors	—	—	4.17

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

The Corporation's credit exposure on interest rate swaps is limited to the net favorable value and interest payments of all swaps by each counterparty. In such cases collateral is required from the counterparties involved if the net value of the swaps exceeds a nominal amount considered to be immaterial. The Corporation's credit exposure, net of any collateral pledged, relating to interest rate swaps was approximately $2.4 million at December 31, 2006. This credit exposure was primarily related to bank customers. Collateral levels are monitored and adjusted on a monthly basis for changes in interest rate swap values.

For fair value hedges, the changes in the fair value of both the derivative hedging instrument and the hedged item are recorded in current earnings as other income or other expense. The extent that such changes in fair value do not offset represents hedge ineffectiveness. For cash flow hedges, the effective portion of the gain or loss on the derivative hedging instrument is reported in other comprehensive income, while the ineffective portion (indicated by the excess of the cumulative change in the fair value of the derivative over that which is necessary to offset the cumulative change in expected future cash flows on the hedge transaction) is recorded in current earnings as other income or other expense. The amount of hedge ineffectiveness reported in earnings was not significant during any of the reported periods. The accumulated net after-tax loss on the floor contracts included in accumulated other comprehensive income totaled $1.1 million at December 31, 2006.

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

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

The notional amounts and estimated fair values of commodity derivative positions outstanding at December 31, 2006 and December 31, 2005 are presented in the following table. The estimated fair values are based on quoted market prices.

		December 31, 2006		December 31, 2005	
	Notional Units	**Notional Amount**	**Estimated Fair Value**	**Notional Amount**	**Estimated Fair Value**
Commodity swaps:					
Oil	Barrels	27	$ 36	—	$ —
Oil	Barrels	27	(29)	—	—
Natural gas	MMBTUs	600	952	130	267
Natural gas	MMBTUs	600	(953)	130	(261)
Commodity options:					
Oil	Barrels	566	1,837	117	155
Oil	Barrels	566	(1,835)	117	(155)
Natural gas	MMBTUs	1,440	1,006	500	594
Natural gas	MMBTUs	1,440	(1,006)	500	(594)

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 December 31, 2006 and 2005.

Note 18 — Fair Value of Financial Instruments

The estimated fair value approximates carrying value for cash and cash equivalents, accrued interest and the cash surrender value of life insurance policies. Fair value estimates for other financial instruments are discussed below:

Securities. Fair value estimates are based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar instruments.

Loans. The estimated fair value approximates carrying value for variable-rate loans that reprice frequently and with no significant change in credit risk. The fair value of fixed-rate loans and variable-rate loans which reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality. Fair values for impaired loans are estimated using a discounted cash flow analysis or the underlying collateral values. Fair value of loans held for sale is based on quoted market prices.

Derivatives. The estimated fair value of the subordinated debt interest rate swap, foreign currency contracts and commodity swaps/options are based on a quoted market price. Internal present value models are used to estimate the fair values of the other interest rate swaps and caps.

Deposits. The estimated fair value approximates carrying value for demand deposits. The fair value of fixed-rate deposit liabilities with defined maturities is estimated by discounting future cash flows using the interest rates currently offered for deposits of similar remaining maturities.

Borrowings. The estimated fair value approximates carrying value for short-term borrowings. The fair value of long-term fixed-rate borrowings is estimated by discounting future cash flows using current interest rates for similar financial instruments.

Junior Subordinated Deferrable Interest Debentures. Fair value is estimated based on the quoted market prices of the instruments.

Subordinated notes payable. Fair value is estimated based on the quoted market prices of similar instruments.

Loan commitments, standby and commercial letters of credit. The Corporation's lending commitments have variable interest rates and "escape" clauses if the customer's credit quality deteriorates. Therefore, the fair values of these items are not significant and are not included in the following table.

The year-end estimated fair values of financial instruments were as follows:

	2006		2005	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 1,444,585	$ 1,444,585	$1,913,428	$1,913,428
Securities	3,350,455	3,350,517	3,078,029	3,078,118
Loans	7,373,384	7,364,545	6,085,055	6,080,469
Allowance for loan losses	(96,085)	—	(80,325)	—
Net loans	7,277,299	7,364,545	6,004,730	6,080,469
Cash surrender value of life insurance policies	111,742	111,742	102,604	102,604
Commercial loan/lease interest rate swaps on loans designated as hedges of fair value	182	182	1,513	1,513
Commercial loan/lease interest rate caps on loans designated as hedges of fair value	—	—	41	41
Interest rate swaps related to subordinated notes	—	—	450	450
Interest rate floors on variable-rate loans designated as hedges of cash flows	366	366	1,702	1,702
Non-hedging commercial loan/lease interest rate swaps caps and floors	3,333	3,333	2,486	2,486
Commodity and foreign exchange derivatives	3,831	3,831	1,016	1,016
Accrued interest receivable	63,824	63,824	50,936	50,936
Financial liabilities:				
Deposits	10,387,909	10,389,906	9,146,394	9,144,011
Federal funds purchased and repurchase agreements	864,190	864,190	740,529	740,529
Junior subordinated deferrable interest debentures	242,270	246,708	226,805	234,022
Subordinated notes payable and other borrowings	186,366	195,319	188,617	199,700
Non-hedging commercial loan/lease interest rate swaps caps and floors	3,333	3,333	2,486	2,486
Commodity and foreign exchange derivatives	3,823	3,823	1,010	1,010
Accrued interest payable	30,170	30,170	24,476	24,476

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Corporation could realize in a current market exchange, nor are they intended to represent the fair value of the Corporation as a whole. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The fair value estimates presented herein are based on pertinent information available to management as of the respective balance sheet date. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

In addition, other assets, such as property and equipment, and liabilities of the Corporation that are not defined as financial instruments are not included in the above disclosures. Also, nonfinancial instruments typically not recognized in financial statements nevertheless may have value but are not included in the above disclosures. These include, among other items, the estimated earning power of core deposit accounts, the trained work force, customer goodwill and similar items.

Note 19 — Operating Segments

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

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

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

Financial results by operating segment were as follows:

	Banking	FMG	Non-Banks	Consolidated
2006				
Net interest income (expense)	$464,032	$ 22,519	$(17,388)	$469,163
Provision for possible loan losses	14,147	3	—	14,150
Non-interest income	161,079	78,401	1,267	240,747
Non-interest expense	340,224	66,056	4,073	410,353
Income (loss) before income taxes	270,740	34,861	(20,194)	285,407
Income tax expense (benefit)	86,599	12,209	(6,992)	91,816
Net income (loss)	$184,141	$ 22,652	$(13,202)	$193,591
Revenues from (expenses to) external customers	$625,111	$100,920	$(16,121)	$709,910
Average assets (in millions)	$ 11,522	$ 44(1)	$ 15	$ 11,581
2005				
Net interest income (expense)	$392,189	$ 13,962	$(14,885)	$391,266
Provision for possible loan losses	10,177	73	—	10,250
Non-interest income	158,474	70,700	1,205	230,379
Non-interest expense	304,965	58,948	3,094	367,007
Income (loss) before income taxes	235,521	25,641	(16,774)	244,388
Income tax expense (benefit)	76,344	8,975	(6,354)	78,965
Net income (loss)	$159,177	$ 16,666	$(10,420)	$165,423
Revenues from (expenses to) external customers	$550,663	$ 84,662	$(13,680)	$621,645
Average assets (in millions)	$ 10,080	$ 47(1)	$ 16	$ 10,143
2004				
Net interest income (expense)	$338,555	$ 4,991	$(12,108)	$331,438
Provision for possible loan losses	2,498	2	—	2,500
Non-interest income	158,977	64,586	1,547	225,110
Non-interest expense	289,452	52,657	2,921	345,030
Income (loss) before income taxes	205,582	16,918	(13,482)	209,018
Income tax expense (benefit)	67,838	5,921	(6,066)	67,693
Net income (loss)	$137,744	$ 10,997	$ (7,416)	$141,325
Revenues from (expenses to) external customers	$497,532	$ 69,577	$(10,561)	$556,548
Average assets (in millions)	$ 9,590	$ 13(1)	$ 16	$ 9,619

(1) Excludes off balance sheet managed and custody assets with a total fair value of $23.2 billion, $18.1 billion and $17.1 billion, at December 31, 2006, 2005 and 2004.

Note 20 — Condensed Financial Statements of Parent Company

Condensed financial statements pertaining only to Cullen/Frost Bankers, Inc. are presented below. Investments in subsidiaries are stated using the equity method of accounting.

Condensed Statements of Income

	Year Ended December 31,		
	2006	2005	2004
Income:			
Dividend income	$101,173	$186,294	$ 74,592
Interest and other income	4,195	2,422	800
Total income	105,368	188,716	75,392
Expenses:			
Interest expense	17,402	14,908	12,144
Salaries and employee benefits	1,798	1,089	2,488
Other	3,523	2,757	2,649
Total expenses	22,723	18,754	17,281
Income before income taxes and equity in undistributed earnings of subsidiaries (distributions in excess of earnings of subsidiaries)	82,645	169,962	58,111
Income tax benefit	7,626	6,843	6,190
Equity in undistributed earnings of subsidiaries (distributions in excess of earnings of subsidiaries)	103,320	(11,382)	77,024
Net income	$193,591	$165,423	$141,325

Condensed Balance Sheets

	December 31,	
	2006	2005
Assets:		
Cash	$ 103,654	$ 124,167
Resell agreements	500	156,976
Total cash and cash equivalents	104,154	281,143
Investment in subsidiaries	1,524,393	931,051
Other assets	5,139	5,701
Total assets	$1,633,686	$1,217,895
Liabilities:		
Junior subordinated deferrable interest debentures	$ 242,270	$ 226,805
Accrued interest payable and other liabilities	14,533	8,854
Total liabilities	256,803	235,659
Shareholders' Equity	1,376,883	982,236
Total liabilities and shareholders' equity	$1,633,686	$1,217,895

Condensed Statements of Cash Flows

	Year Ended December 31,		
	2006	2005	2004
Operating Activities:			
Net income	$ 193,591	$165,423	$141,325
Adjustments to reconcile net income to net cash provided by operating activities:			
(Equity in undistributed earnings of subsidiaries) distributions in excess of earnings of subsidiaries	(103,320)	11,382	(77,024)
Stock-based compensation	9,240	1,986	1,377
Tax benefits from stock-based compensation	—	11,371	11,524
Excess tax benefits from stock-based compensation	(15,625)	—	—
Net change in other assets and other liabilities	23,697	(5,889)	(3,127)
Net cash from operating activities	107,583	184,273	74,075
Investing Activities:			
Net cash paid in acquisitions	(100,074)	(13,297)	—
Capital contributions to subsidiaries	(164,760)	(33,623)	(3,712)
Net cash from investing activities	(264,834)	(46,920)	(3,712)
Financing Activities:			
Proceeds from junior subordinated deferrable interest debentures	—	—	123,712
Proceeds from stock option exercises	42,703	35,805	36,006
Excess tax benefits from stock-based compensation	15,625	—	—
Purchase of treasury stock	(4,666)	(14,972)	(65,212)
Cash dividends paid	(73,400)	(61,499)	(53,782)
Net cash from financing activities	(19,738)	(40,666)	40,724
Net change in cash and cash equivalents	(176,989)	96,687	111,087
Cash and cash equivalents at beginning of year	281,143	184,456	73,369
Cash and cash equivalents at end of year	$ 104,154	$281,143	$184,456

Note 21 — New Accounting Standards

Statements of Financial Accounting Standards

SFAS No. 123, "Share-Based Payment (Revised 2004)." SFAS 123R establishes standards for the accounting for transactions in which an entity (i) exchanges its equity instruments for goods or services, or (ii) incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of the equity instruments. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which is generally the date of the grant. The Corporation adopted the provisions of SFAS 123R on January 1, 2006. Details related to the adoption of SFAS 123R and the impact to the Corporation's financial statements are more fully discussed in Note 13 — Employee Benefit Plans.

SFAS No. 154, "Accounting Changes and Error Corrections, a Replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. Previously, most changes in accounting principle were recognized by including the cumulative effect of changing to the new accounting principle in net income of the period of the change. SFAS 154 carries forward the guidance in APB Opinion 20 "Accounting Changes," requiring justification of a change in accounting principle on the basis of preferability. SFAS 154 also carries forward without change the guidance contained in APB Opinion 20, for reporting the correction of an error in previously issued financial statements and for a change in an accounting estimate. The adoption of SFAS 154 on January 1, 2006 did not significantly impact the Corporation's financial statements.

SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments — an amendment of FASB Statements No. 133 and 140." SFAS 155 amends SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for the Corporation on January 1, 2007 and is not expected to have a significant impact on the Corporation's financial statements.

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

SFAS No. 157, "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Corporation on January 1, 2008 and is not expected to have a significant impact on the Corporation's financial statements.

SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88 106, and 132(R)." SFAS 158 requires an employer to recognize the overfunded or underfunded status of defined benefit post-retirement benefit plans as an asset or a liability in its statement of financial position. The funded status is measured as the difference between plan assets at fair value and the benefit obligation (the projected benefit obligation for pension plans or the accumulated benefit obligation for other post-retirement benefit plans). An employer is also required to measure the funded status of a plan as of the date of its year-end statement of financial position with changes in the funded status recognized through comprehensive income. SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses, prior service costs or credits, and the transition asset or obligation. The Corporation was required to recognize the funded status of its defined benefit post-retirement benefit plans in its financial statements for the year ended December 31, 2006. The Corporation had previously recognized the funded status of its Retirement and Restoration plans in prior financial statements. The effect of recognizing the funded status of other defined benefit post-retirement benefit plans was not significant. See Note 13 — Employee Benefit Plans for additional information related to these plans. The requirement to measure plan assets and benefit obligations as of the date of the year-end statement of financial position is effective for the Corporation's financial statements beginning with the year ended after December 31, 2008. The Corporation currently uses December 31 as the measurement date for its defined benefit post-retirement benefit plans.

Financial Accounting Standards Board Staff Positions and Interpretations

FASB Staff Position (FSP) No. 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." FSP 115-1 provides guidance for determining when an investment is considered impaired, whether impairment is other-than-temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other-than-temporary, then an impairment loss should be recognized equal to the difference between the investment's cost and its fair value. FSP 115-1 nullifies certain provisions of Emerging Issues Task Force (EITF) Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," while retaining the disclosure requirements of EITF 03-1 which were adopted in 2003. The adoption of FSP 115-1 on January 1, 2006 did not significantly impact the Corporation's financial statements.

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

American Institute of Certified Public Accountants Statements of Position

SOP No. 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer." SOP 03-3 addresses accounting for differences between the contractual cash flows of certain loans and debt securities and the cash flows expected to be collected when loans or debt securities are acquired in a transfer and those cash flow differences are attributable, at least in part, to credit quality. As such, SOP 03-3 applies to loans and debt securities acquired individually, in pools or as part of a business combination and does not apply to originated loans. The application of SOP 03-3 limits the interest income, including accretion of purchase price discounts, that may be recognized for certain loans and debt securities. Additionally, SOP 03-3 does not allow the excess of contractual cash flows over cash flows expected to be collected to be recognized as an adjustment of yield, loss accrual or valuation allowance, such as the allowance for possible loan losses. SOP 03-3 requires that increases in expected cash flows subsequent to the initial investment be recognized prospectively through adjustment of the yield on the loan or debt security over its remaining life. Decreases in expected cash flows should be recognized as impairment. In the case of loans acquired in a business combination where the loans show signs of credit deterioration, SOP 03-3 represents a significant change from prior purchase accounting practice whereby the acquiree's allowance for loan losses was typically added to the acquirer's allowance for loan losses. The adoption of SOP 03-3 on January 1, 2005 did not have a material impact on the Corporation's financial statements.

SEC Staff Accounting Bulletins

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

Cullen/Frost Bankers, Inc.
Consolidated Average Balance Sheets
(Dollars in thousands — tax-equivalent basis)

The following unaudited schedule is presented for additional information and analysis

	2006 Average Balance	2006 Interest Income/ Expense	2006 Yield/ Cost	2005 Average Balance	2005 Interest Income/ Expense	2005 Yield/ Cost
Assets:						
Interest-bearing deposits	$ 4,000	$ 251	6.28%	$ 5,644	$ 150	2.66%
Federal funds sold and resell agreements	718,950	36,550	5.08	521,674	18,147	3.48
Securities:						
Tax-exempt	275,419	17,685	6.46	260,207	16,521	6.48
Taxable	2,680,706	133,184	4.85	2,586,904	121,377	4.68
Total securities	2,956,125	150,869	5.00	2,847,111	137,898	4.84
Loans, net of unearned discount	6,523,906	506,264	7.76	5,594,477	361,304	6.46
Total earning assets and average rate earned	10,202,981	693,934	6.76	8,968,906	517,499	5.77
Cash and due from banks	615,609			604,625		
Allowance for possible loan losses	(85,038)			(77,551)		
Premises and equipment, net	200,008			175,829		
Accrued interest receivable and other assets	647,693			471,436		
Total assets	$11,581,253			$10,143,245		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	$ 3,005,811			$ 2,639,071		
Correspondent banks	277,332			323,712		
Public funds	51,137			45,967		
Total non-interest-bearing demand deposits	3,334,280			3,008,750		
Interest-bearing deposits:						
Private accounts:						
Savings and interest checking	1,283,830	4,579	0.36	1,206,055	3,009	0.25
Money market deposit accounts	3,022,866	92,075	3.05	2,646,975	48,158	1.82
Time accounts	1,122,979	42,806	3.81	894,459	20,499	2.29
Public funds	420,441	15,630	3.72	376,547	7,268	1.93
Total interest-bearing deposits	5,850,116	155,090	2.65	5,124,036	78,934	1.54
Total deposits	9,184,396			8,132,786		
Federal funds purchased and repurchase agreements	764,173	31,167	4.08	605,965	16,632	2.74
Junior subordinated deferrable interest debentures	230,178	17,402	7.56	226,805	14,908	6.57
Subordinated notes payable and other notes	150,000	9,991	6.66	150,000	7,626	5.08
Federal Home Loan Bank advances	25,574	1,146	4.48	10,807	461	4.27
Total interest-bearing liabilities and average rate paid	7,020,041	214,796	3.06	6,117,613	118,561	1.94
Accrued interest payable and other liabilities	153,333			136,242		
Total liabilities	10,507,654			9,262,605		
Shareholders' equity	1,073,599			880,640		
Total liabilities and shareholder's equity	$11,581,253			$10,143,245		
Net interest income		$479,138			$398,938	
Net interest spread			3.70%			3.83%
Net interest income to total average earning assets			4.67%			4.45%

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.

Year Ended December 31,											
2004			2003			2002			2001		
Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
$ 6,175	$ 63	1.02%	$ 8,869	$ 104	1.17%	$ 14,220	$ 199	1.40%	$ 7,170	$ 331	4.62%
564,286	8,834	1.57	825,452	9,601	1.16	244,790	3,991	1.63	253,112	9,784	3.87
219,674	14,138	6.68	200,844	13,184	6.56	181,928	12,697	6.98	167,369	11,863	7.08
2,739,001	125,999	4.63	2,478,427	117,342	4.73	1,983,502	112,079	5.65	1,590,431	99,323	6.25
2,958,675	140,137	4.77	2,679,271	130,526	4.87	2,165,430	124,776	5.76	1,757,800	111,186	6.33
4,823,198	250,174	5.19	4,497,489	233,902	5.20	4,536,999	265,931	5.86	4,546,596	344,413	7.58
8,352,334	399,208	4.79	8,011,081	374,133	4.67	6,961,439	394,897	5.67	6,564,678	465,714	7.09
746,257			1,046,690			893,995			810,323		
(81,232)			(83,616)			(79,394)			(68,785)		
168,714			168,705			161,941			150,264		
432,776			440,969			415,164			385,343		
$9,618,849			$9,583,829			$8,353,145			$7,841,823		
$2,395,663			$2,133,906			$1,942,228			$1,883,931		
469,635			848,737			553,318			262,840		
49,222			55,081			44,886			39,919		
2,914,520			3,037,724			2,540,432			2,186,690		
1,171,883	1,090	0.09	1,052,637	916	0.09	1,003,713	1,800	0.18	966,429	3,605	0.37
2,444,734	24,508	1.00	2,153,489	20,601	0.96	1,857,130	23,860	1.28	1,825,991	48,011	2.63
865,176	10,173	1.18	1,001,581	12,793	1.28	1,155,746	24,767	2.14	1,265,999	57,101	4.51
370,373	3,379	0.91	331,915	3,096	0.93	337,289	4,956	1.47	306,248	9,982	3.26
4,852,166	39,150	0.81	4,539,622	37,406	0.82	4,353,878	55,383	1.27	4,364,667	118,699	2.72
7,766,686			7,577,346			6,894,310			6,551,357		
564,489	5,775	1.02	854,517	4,059	0.48	400,511	5,359	1.34	351,319	12,054	3.43
212,271	12,144	5.72	103,093	8,735	8.47	103,093	8,735	8.47	103,093	8,735	8.47
150,000	4,974	3.32	150,399	4,645	3.09	152,062	5,902	3.88	65,662	3,736	5.69
1,115	63	5.65	10,936	343	3.14	19,981	746	3.73	31,411	1,795	5.71
5,780,041	62,106	1.07	5,658,567	55,188	0.98	5,029,525	76,125	1.51	4,916,152	145,019	2.95
135,215			153,544			131,915			124,971		
8,829,776			8,849,835			7,701,872			7,227,813		
789,073			733,994			651,273			614,010		
$9,618,849			$9,583,829			$8,353,145			$7,841,823		
	$337,102			$318,945			$318,772			$320,695	
		3.72%			3.69%			4.16%			4.14%
		4.05%			3.98%			4.58%			4.89%

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A. CONTROLS AND PROCEDURES

As of the end of the period covered by this Annual Report on Form 10-K, 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 changes were made to the Corporation's internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) during the last fiscal quarter that materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

The management of Cullen/Frost Bankers, Inc. (the "Corporation") is responsible for establishing and maintaining adequate internal control over financial reporting. The Corporation's internal control over financial reporting is a process designed under the supervision of the Corporation's Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Corporation's financial statements for external purposes in accordance with generally accepted accounting principles.

As of December 31, 2006, management assessed the effectiveness of the Corporation's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in "Internal Control — Integrated Framework," issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on the assessment, management determined that the Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on those criteria.

Ernst & Young LLP, the independent registered public accounting firm that audited the consolidated financial statements of the Corporation included in this Annual Report on Form 10-K, has issued an attestation report on management's assessment of the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2006. The report, which expresses unqualified opinions on management's assessment and on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2006, is included in this Item under the heading "Attestation Report of Independent Registered Public Accounting Firm."

Attestation Report of Independent Registered Public Accounting Firm

Report of Ernst & Young LLP
Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
of Cullen/Frost Bankers, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Cullen/Frost Bankers, Inc. (the "Corporation") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Cullen/Frost Bankers, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Cullen/Frost Bankers, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Cullen/Frost Bankers, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006 of Cullen/Frost Bankers, Inc. and our report dated February 2, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

San Antonio, Texas
February 2, 2007

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Certain information regarding executive officers is included under the section captioned "Executive Officers of the Registrant" in Part I, Item 1, elsewhere in this Annual Report on Form 10-K. Other information required by this Item is incorporated herein by reference to the Corporation's Proxy Statement (Schedule 14A) for its 2007 Annual Meeting of Shareholders to be filed with the SEC within 120 days of the Corporation's fiscal year-end.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the Corporation's Proxy Statement (Schedule 14A) for its 2007 Annual Meeting of Shareholders to be filed with the SEC within 120 days of the Corporation's fiscal year-end.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Certain information regarding securities authorized for issuance under the Corporation's equity compensation plans is included under the section captioned "Stock-Based Compensation Plans" in Part II, Item 5, elsewhere in this Annual Report on Form 10-K. Other information required by this Item is incorporated herein by reference to the Corporation's Proxy Statement (Schedule 14A) for its 2007 Annual Meeting of Shareholders to be filed with the SEC within 120 days of the Corporation's fiscal year-end.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to the Corporation's Proxy Statement (Schedule 14A) for its 2007 Annual Meeting of Shareholders to be filed with the SEC within 120 days of the Corporation's fiscal year-end.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is incorporated herein by reference to the Corporation's Proxy Statement (Schedule 14A) for its 2007 Annual Meeting of Shareholders to be filed with the SEC within 120 days of the Corporation's fiscal year-end.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1. *Consolidated Financial Statements.* Reference is made to Part II, Item 8, of this Annual Report on Form 10-K.

2. *Consolidated Financial Statement Schedules.* These schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.

3. *Exhibits.* The exhibits to this Annual Report on Form 10-K listed below have been included only with the copy of this report filed with the Securities and Exchange Commission. Copies of individual exhibits will be furnished to shareholders upon written request to Cullen/Frost and payment of a reasonable fee.

Exhibit Number	Exhibit Description	Filed Herewith	Incorporated by Reference			
			Form	File No.	Exhibit	Filing Date
3.1	Restated Articles of Incorporation of Cullen/Frost Bankers, Inc.		10-Q	0-7275	3.1	7/26/06
3.2	Amended By-Laws of Cullen/Frost Bankers, Inc.		10-K/A	0-7275	3.2	4/29/96
4.1	Shareholder Protection Rights Agreement dated as of January 26, 1999 between Cullen/Frost Bankers, Inc. and The Frost National Bank, as Rights Agent		8-A	0-7275	1	2/1/99
4.2*	Instruments Defining the Rights of Holders of Long-Term Debt					
10.1+	Restoration of Retirement Income Plan for Participants in the Retirement Plan for Employees of Cullen/Frost Bankers, Inc. and its Affiliates (as amended and restated)		10-K	0-7275	10.1	3/31/99
10.2+	The 401(k) Stock Purchase Plan for Employees of Cullen/Frost Bankers, Inc. and its Affiliates		S-8	333-108321	4.4	8/28/03
10.3+	1991 Thrift Incentive Stock Purchase Plan for Employees of Cullen/Frost Bankers, Inc. and its Affiliates		S-8	33-39478	4.4	3/18/91
10.4+	Cullen/Frost Bankers, Inc. Restricted Stock Plan		S-8	33-53492	4.4	10/20/92
10.5+	Cullen/Frost Bankers, Inc. Supplemental Executive Retirement Plan		10-K	0-7275	10.13	3/30/95
10.6+	Cullen/Frost Bankers, Inc. 1997 Director Stock Plan		S-8	333-102133	4.4	12/23/02
10.7+	Cullen/Frost Bankers, Inc. 1992 Stock Plan, as amended		S-8	333-68928	4.5 — 4.7	9/4/01
10.8+	Change-In-Control Agreements with 3 Executive Officers		10-K	0-7275	10.10	3/28/01
10.9+	Cullen/Frost Bankers, Inc. 2001 Stock Plan		S-8	333-68928	4.4	9/4/01
10.10+	Retirement Agreement with a former Executive Officer		10-K	0-7275	10.10	3/28/03

Exhibit Number	Exhibit Description	Filed Herewith	Incorporated by Reference			
			Form	File No.	Exhibit	Filing Date
10.11+	Deferred Compensation Plan for Covered Employees		10-K	0-7275	10.11	3/28/03
10.12+	Cullen/Frost Restoration Profit Sharing Plan		10-K	0-7275	10.12	2/4/05
10.13+	2005 Omnibus Incentive Plan		S-8	333-127341	4.4	8/9/05
21.1	Subsidiaries of Cullen/Frost Bankers, Inc.	X				
23.1	Consent of Independent Registered Public Accounting Firm	X				
24.1	Power of Attorney	X				
31.1	Rule 13a-14(a) Certification of the Chief Executive Officer	X				
31.2	Rule 13a-14(a) Certification of the Chief Financial Officer	X				
32.1++	Section 1350 Certification of the Chief Executive Officer	X				
32.2++	Section 1350 Certification of the Chief Financial Officer	X				

* The Corporation agrees to furnish to the SEC, upon request, copies of any such instruments.

\+ Management contract or compensatory plan or arrangement.

++ 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.

(b) Exhibits — See exhibit index included in Item 15(a)3 of this Annual Report on Form 10-K.

(c) Financial Statement Schedules — See Item 15(a)2 of this Annual Report on Form 10-K.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: February 2, 2007

CULLEN/FROST BANKERS, INC.
(Registrant)

By: /s/ PHILLIP D. GREEN

Phillip D. Green
Group Executive Vice President and
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ T.C. FROST* **T.C. Frost**	Senior Chairman of the Board and Director	February 2, 2007
/s/ RICHARD W. EVANS, JR.* **Richard W. Evans, Jr.**	Chairman of the Board and Director (Principal Executive Officer)	February 2, 2007
/s/ PHILLIP D. GREEN **Phillip D. Green**	Group Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 2, 2007
/s/ R. DENNY ALEXANDER* **R. Denny Alexander**	Director	February 2, 2007
/s/ CARLOS ALVAREZ* **Carlos Alvarez**	Director	February 2, 2007
/s/ ROYCE S. CALDWELL* **Royce S. Caldwell**	Director	February 2, 2007
/s/ CRAWFORD H. EDWARDS **Crawford H. Edwards**	Director	February 2, 2007
/s/ RUBEN M. ESCOBEDO* **Ruben M. Escobedo**	Director	February 2, 2007

SIGNATURES — (Continued)

Signature	Title	Date
/s/ PATRICK B. FROST* **Patrick B. Frost**	Director and President of The Frost National Bank	February 2, 2007
/s/ KAREN E. JENNINGS* **Karen E. Jennings**	Director	February 2, 2007
/s/ RICHARD M. KLEBERG, III* **Richard M. Kleberg, III**	Director	February 2, 2007
/s/ ROBERT S. MCCLANE* **Robert S. McClane**	Director	February 2, 2007
/s/ IDA CLEMENT STEEN* **Ida Clement Steen**	Director	February 2, 2007
/s/ HORACE WILKINS, JR.* **Horace Wilkins, Jr.**	Director	February 2, 2007
*By: /s/ PHILLIP D. GREEN **Phillip D. Green** As attorney-in-fact for the persons indicated	Group Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 2, 2007

Exhibit 21.1

Subsidiaries of Cullen/Frost Bankers, Inc.

Name of Subsidiary	State or Other Jurisdiction of Incorporation or Organization	Percentage of Voting Securities Owned by Cullen/Frost Bankers, Inc.
The New Galveston Company, Inc.	Delaware	100%
Cullen/Frost Capital Trust I	Delaware	100%
Cullen/Frost Capital Trust II	Delaware	100%
Alamo Corporation of Texas Trust I	Delaware	100%
Summit Bancshares Statutory Trust I	Delaware	100%
The Frost National Bank	United States	100%
Main Plaza Corporation	Texas	100%
Daltex General Agency, Inc.	Texas	100%
Frost Securities, Inc.	Delaware	100%
Frost Insurance Agency, Inc.	Texas	100%
Frost Brokerage Services, Inc.	Texas	100%
Frost Premium Finance Corporation	Texas	100%
Tri-Frost Corporation	Texas	100%
Carton Service Corporation	Texas	100%
Cullen BLP, Inc.	Texas	100%

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in the Registration Statement (Form S-8 No. 333-127341) pertaining to the 2005 Omnibus Incentive Plan, the Registration Statements (Form S-8 No. 333-37500 and No. 333-108321) pertaining to The 401(k) Stock Purchase Plan for Employees of Cullen/Frost Bankers, Inc. and its Affiliates, the Registration Statement (Form S-8 No. 33-39478) pertaining to the 1991 Thrift Incentive Stock Purchase Plan for Employees of Cullen/Frost Bankers, Inc. and its Affiliates, the Registration Statement (Form S-8 No. 33-53492) pertaining to the Cullen/Frost Bankers, Inc. Restricted Stock Plan, the Registration Statement (Form S-8 No. 33-53622) pertaining to the Cullen/Frost Bankers, Inc. 1992 Stock Plan, the Registration Statement (Form S-8 No. 333-68928) pertaining to the Cullen/Frost Bankers, Inc. 2001 Stock Plan, and the Registration Statement (Form S-8 No. 333-102133) pertaining to the 1997 Director Stock Plan of Cullen/Frost Bankers, Inc. of our reports dated February 2, 2007, with respect to the consolidated financial statements of Cullen/Frost Bankers, Inc., Cullen/Frost Bankers, Inc. management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Cullen/Frost Bankers, Inc., included in the Annual Report (Form 10-K) for the year ended December 31, 2006.

/s/ Ernst & Young LLP

San Antonio, Texas
February 2, 2007

Exhibit 24.1

Power of Attorney

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Patrick B. Frost, Richard W. Evans, Jr. and Phillip D. Green, and each of them, his or her true and lawful attorneys-in-fact and agents, and with power of substitution and resubstitution, for him/her and in his/her name, place and stead, and in any and all capacities, to sign the Annual Report on Form 10-K of Cullen/Frost Bankers, Inc. for the fiscal year ended December 31, 2006, to sign any and all amendments thereto, and to file such Annual Report and amendments, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as he/she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or either of them, or their or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Signature	Title	Date
/s/ T.C. FROST **T.C. Frost**	Senior Chairman of the Board and Director	January 25, 2007
/s/ RICHARD W. EVANS, JR. **Richard W. Evans, Jr.**	Chairman of the Board and Director (Principal Executive Officer)	January 25, 2007
/s/ PHILLIP D. GREEN **Phillip D. Green**	Group Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	January 25, 2007
/s/ R. DENNY ALEXANDER **R. Denny Alexander**	Director	January 25, 2007
/s/ CARLOS ALVAREZ **Carlos Alvarez**	Director	January 25, 2007
/s/ ROYCE S. CALDWELL **Royce S. Caldwell**	Director	January 25, 2007
/s/ CRAWFORD H. EDWARDS **Crawford H. Edwards**	Director	January 25, 2007
/s/ RUBEN M. ESCOBEDO **Ruben M. Escobedo**	Director	January 25, 2007
/s/ PATRICK B. FROST **Patrick B. Frost**	Director and President of The Frost National Bank	January 25, 2007
/s/ KAREN E. JENNINGS **Karen E. Jennings**	Director	January 25, 2007
/s/ RICHARD M. KLEBERG, III **Richard M. Kleberg, III**	Director	January 25, 2007
/s/ ROBERT S. McCLANE **Robert S. McClane**	Director	January 25, 2007
/s/ IDA CLEMENT STEEN **Ida Clement Steen**	Director	January 25, 2007
/s/ HORACE WILKINS, JR. **Horace Wilkins, Jr.**	Director	January 25, 2007

Exhibit 31.1

Rule 13a-14(a) Certification
of the Chief Executive Officer

I, Richard W. Evans, Jr., certify that:

1. I have reviewed this Annual Report on Form 10-K of Cullen/Frost Bankers, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 2, 2007

/s/ Richard W. Evans, Jr.

Richard W. Evans, Jr.
Chief Executive Officer

Exhibit 31.2

Rule 13a-14(a) Certification
of the Chief Financial Officer

I, Phillip D. Green, certify that:

1. I have reviewed this Annual Report on Form 10-K of Cullen/Frost Bankers, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 2, 2007

/s/ Phillip D. Green

Phillip D. Green
Group Executive Vice President and
Chief Financial Officer

Exhibit 32.1

Section 1350 Certification of the
Chief Executive Officer

Pursuant to Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned, Richard W. Evans, Jr., Chief Executive Officer, of Cullen/Frost Bankers, Inc. (the "Corporation"), hereby certifies, to his knowledge, that the Corporation's Annual Report on Form 10-K for the year ended December 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

/s/ Richard W. Evans, Jr. February 2, 2007
Richard W. Evans, Jr.

The forgoing certification is being furnished solely pursuant to Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002 and 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.

Exhibit 32.2

Section 1350 Certification of the Chief Financial Officer

Pursuant to Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned, Phillip D. Green, Chief Financial Officer, of Cullen/Frost Bankers, Inc. (the "Corporation"), hereby certifies, to his knowledge, that the Corporation's Annual Report on Form 10-K for the year ended December 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

/s/ Phillip D. Green	February 2, 2007
Phillip D. Green	

The forgoing certification is being furnished solely pursuant to Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002 and 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.