CULLEN FROST BANKERS INC
Form 10-K
February 01, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

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

For the fiscal year ended: December 31, 2007
or

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

For the transition period from _____ to _____

Commission file number: 001-13221

CULLEN/FROST BANKERS, INC.
(Exact name of registrant as specified in its charter)

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 þ No o

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 o No þ

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 þ No o

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. o

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 þ Accelerated filer o Non-accelerated filer o

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

As of June 30, 2007, 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 24, 2008, there were 58,696,530 shares of the registrant s common stock, $.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2008 Annual Meeting of Shareholders of Cullen/Frost Bankers, Inc. to be held on April 24, 2008 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

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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, 2007, Cullen/Frost had consolidated total assets of $13.5 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 2007, the Corporation acquired Prime Benefits, Inc. (Austin market area), an independent insurance agency that specializes in providing employee benefits to businesses. 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.

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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 II, Alamo Corporation of Texas Trust I and Summit Bancshares Statutory Trust I.

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

Cullen/Frost Capital Trust II (Trust II) is a Delaware statutory business trust formed in 2004 for the purpose of issuing $120.0 million 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. Cullen/Frost acquired Alamo Trust 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 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, the accounts of the Capital Trusts are not included in the Corporation s consolidated financial statements. 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 $135.0 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 $135.0 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.

On January 7, 2008, the Corporation redeemed $3.1 million of floating rate (three-month LIBOR plus a margin of 3.30%) junior subordinated deferrable interest debentures, due January 7, 2033, held of record by Alamo Trust. Concurrently, the $3.0 million of floating rate (three-month LIBOR plus a margin of 3.30%) trust preferred securities issued by Alamo Trust were also redeemed. On February 21, 2007, the Corporation redeemed $103.1 million of

8.42% junior subordinated deferrable interest debentures, Series A due February 1, 2027, held of record by Cullen/Frost Capital Trust I, a prior Delaware statutory business trust wholly-owned by the Corporation. As a result of the redemption, the Corporation incurred $5.3 million in expense during the first quarter of 2007 related to a prepayment penalty and the write-off of the unamortized debt issuance costs.

Concurrently, the $100 million of 8.42% trust preferred securities issued by Cullen/Frost Capital Trust I were also redeemed. See Note 9 Borrowed Funds 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, 2007, Frost Bank had consolidated total assets of $13.5 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 300 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, 2007, the estimated fair value of trust assets was $24.8 billion, including managed assets of $10.5 billion and custody assets of $14.3 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 Financial Industry Regulatory Authority (FINRA) 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

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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 $189.2 million to Cullen/Frost, without obtaining affirmative governmental approvals, at December 31, 2007. 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 such resources. 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

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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, significant 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, 2007, 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 and (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 (BIS II). BIS II provides two approaches for setting capital standards for credit risk an internal ratings-based approach tailored to individual institutions circumstances 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 November 2007, the agencies adopted a definitive final rule for implementing BIS II in the United States that would apply only to internationally active banking organizations, or core banks defined as those with consolidated total assets of $250 billion or more or consolidated on-balance sheet foreign exposures of $10 billion or more. The final rule will be effective as of April 1, 2008. Other U.S. banking organizations may elect to adopt the requirements of this rule (if they meet applicable qualification requirements), but they will not be required to apply them. The rule also allows a banking organization s primary federal supervisor to determine that the application of the rule would not be appropriate in light of the bank s asset size, level of complexity, risk profile, or scope of operations. This new proposal, which is intended to be finalized before the core banks may start their first transition period year under BIS II, will replace the agencies earlier proposed amendments to existing risk-based capital guidelines to make them more risk sensitive (formerly referred to as the BIS I-A approach).

The Corporation is not required to comply with BIS II. The Corporation has not made a determination as to whether it will elect to apply the BIS II requirements when 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 (CAMELS rating). As of January 1, 2007, the previous nine risk categories utilized in the risk matrix were condensed into four risk categories which continue to be distinguished by capital levels and supervisory ratings. For large, Risk Category 1 institutions (generally those with assets in excess of $10 billion) that have long-term debt issuer ratings, including Frost Bank, assessment rates are determined from weighted-average CAMELS component ratings and long-term debt issuer ratings. The minimum annualized assessment rate for large institutions is 5 basis points per $100 of deposits and the maximum annualized assessment rate is 7 basis points per $100 of deposits. Quarterly assessment rates for large institutions in Risk Category 1 may vary within this range depending upon changes in CAMELS component ratings and long-term debt issuer ratings.

Frost Bank was not required to pay any deposit insurance assessments in 2007. 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. This credit was utilized to offset $4.2 million of assessments during 2007. As of December 31, 2007, approximately $4.0 million of the credit remained available to offset future deposit insurance assessments. The Corporation expects this credit to be available to offset assessments through the second quarter of 2008. This credit is not available to offset Financing Corporation (FICO) assessments. Frost Bank paid $1.2 million in FICO assessments during 2007 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, 2007, the Corporation employed 3,781 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, 2007, 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	80	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	61	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	47	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	53	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	57	Officer of Frost Bank since July 1973. President, Chief Business Banking Officer of Frost Bank from February 2001 to present.

Name and Position Held	Age	Recent Business Experience
Robert A. Berman Group Executive Vice President, Internet Financial Services of Frost Bank	45	Officer of Frost Bank since January 1989. Group Executive Vice President, Internet Financial Services of Frost Bank from May 2001 to present.
Paul H. Bracher President, State Regions of Frost Bank	51	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	61	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	55	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	50	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	63	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, 2007, 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 2007, the Corporation acquired Prime Benefits, Inc. (Austin market area). 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.

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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

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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 2007.

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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 2007 and 2006 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.

	2007		2006	
Sales Price Per Share	**High**	**Low**	**High**	**Low**
First quarter	$ 57.05	$ 51.24	$ 55.88	$ 52.34
Second quarter	54.18	50.49	58.49	52.04
Third quarter	55.00	48.34	59.55	54.48
Fourth quarter	54.00	47.55	58.67	53.09

Cash Dividends Per Share	**2007**	**2006**
First quarter	$ 0.34	$ 0.30
Second quarter	0.40	0.34
Third quarter	0.40	0.34
Fourth quarter	0.40	0.34
Total	$ 1.54	$ 1.32

As of December 31, 2007, there were 58,662,130 shares of the Corporation s common stock outstanding held by 1,804 holders of record. The closing price per share of common stock on December 31, 2007, the last trading day of the Corporation s fiscal year, was $50.66.

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, 2007, 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	4,526,276	$ 45.44	1,896,150
Plans not approved by shareholders			
Total	4,526,276	$ 45.44	1,896,150

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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 current plan, which was approved on April 26, 2007, the Corporation was authorized to repurchase up to 2.5 million shares of its common stock from time to time over a two-year period in the open market or through private transactions. Under the plan, the Corporation repurchased 2.1 million shares at a total cost of $109.4 million during 2007. Under the prior 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. No shares were repurchased during 2006. During 2005, the Corporation repurchased 300 thousand shares at a cost of $14.4 million. Over the life of this 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 2007.

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, 2007 to October 31, 2007	19,381(1)	$ 50.73		403,764
November 1, 2007 to November 30, 2007				403,764
December 1, 2007 to December 31, 2007				403,764
Total	19,381	$ 50.73		

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

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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, measured at the last trading day of each year shown. The graph assumes an investment of $100 on December 31, 2002 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, 2002

	2002	2003	2004	2005	2006	2007
Cullen/Frost	$ 100.00	$ 127.46	$ 156.18	$ 176.66	$ 188.05	$ 175.82
S&P 500	100.00	128.63	142.59	149.58	173.15	182.64
S&P 500 Banks	100.00	126.36	139.06	135.21	156.65	109.95

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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, 2007. 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, 2007 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,				
	2007	**2006**	**2005**	**2004**	**2003**
Consolidated Statements of Income					
Interest income:					
Loans, including fees	$ 573,039	$ 502,657	$ 359,587	$ 249,612	$ 233,463
Securities	165,517	144,501	131,943	135,035	125,778
Interest-bearing deposits	396	251	150	63	104
Federal funds sold and resell agreements	29,895	36,550	18,147	8,834	9,601
Total interest income	768,847	683,959	509,827	393,544	368,946
Interest expense:					
Deposits	190,237	155,090	78,934	39,150	37,406
Federal funds purchased and repurchase agreements	31,951	31,167	16,632	5,775	4,059
Junior subordinated deferrable interest debentures	11,283	17,402	14,908	12,143	8,735
Subordinated notes payable and other borrowings	16,639	11,137	8,087	5,038	4,988
Total interest expense	250,110	214,796	118,561	62,106	55,188
Net interest income	518,737	469,163	391,266	331,438	313,758
Provision for possible loan losses	14,660	14,150	10,250	2,500	10,544
Net interest income after provision for possible loan losses	504,077	455,013	381,016	328,938	303,214
Non-interest income:					
Trust fees	70,359	63,469	58,353	53,910	47,486
Service charges on deposit accounts	80,718	77,116	78,751	87,415	87,805
Insurance commissions and fees	30,847	28,230	27,731	30,981	28,660
Other charges, commissions and fees	32,558	28,105	23,125	22,877	22,522

Net gain (loss) on securities transactions	15	(1)	19	(3,377)	40
Other	53,734	43,828	42,400	33,304	28,848
Total non-interest income	268,231	240,747	230,379	225,110	215,361
Non-interest expense:					
Salaries and wages	209,982	190,784	166,059	158,039	146,622
Employee benefits	47,095	46,231	41,577	40,176	38,316
Net occupancy	38,824	34,695	31,107	29,375	29,286
Furniture and equipment	32,821	26,293	23,912	22,771	21,768
Intangible amortization	8,860	5,628	4,859	5,346	5,886
Other	124,864	106,722	99,493	89,323	84,157
Total non-interest expense	462,446	410,353	367,007	345,030	326,035
Income before income taxes	309,862	285,407	244,388	209,018	192,540
Income taxes	97,791	91,816	78,965	67,693	62,039
Net income	$ 212,071	$ 193,591	$ 165,423	$ 141,325	$ 130,501

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	As of or for the Year Ended December 31,				
	2007	2006	2005	2004	2003
Per Common Share Data					
Net income basic	$ 3.60	$ 3.49	$ 3.15	$ 2.74	$ 2.54
Net income diluted	3.55	3.42	3.07	2.66	2.48
Cash dividends declared and paid	1.54	1.32	1.165	1.035	0.94
Book value	25.18	23.01	18.03	15.84	14.87
Common Shares Outstanding					
Period-end	58,662	59,839	54,483	51,924	51,776
Weighted-average shares basic	58,952	55,467	52,481	51,651	51,442
Dilutive effect of stock compensation	761	1,175	1,322	1,489	1,216
Weighted-average shares diluted	59,713	56,642	53,803	53,140	52,658
Performance Ratios					
Return on average assets:	1.63%	1.67%	1.63%	1.47%	1.36%
Return on average equity:	15.20	18.03	18.78	17.91	17.78
Net interest income to average earning assets	4.69	4.67	4.45	4.05	3.98
Dividend pay-out ratio	42.83	37.91	37.18	38.06	37.15
Balance Sheet Data					
Period-end:					
Loans	$ 7,769,362	$ 7,373,384	$ 6,085,055	$ 5,164,991	$ 4,590,746
Earning assets	11,556,385	11,460,741	10,197,059	8,891,859	8,132,479
Total assets	13,485,014	13,224,189	11,741,437	9,952,787	9,672,114
Non-interest-bearing demand deposits	3,597,903	3,699,701	3,484,932	2,969,387	3,143,473
Interest-bearing deposits	6,931,770	6,688,208	5,661,462	5,136,291	4,925,384
Total deposits	10,529,673	10,387,909	9,146,394	8,105,678	8,068,857
Long-term debt and other borrowings	400,323	428,636	415,422	377,677	255,845
Shareholders equity	1,477,088	1,376,883	982,236	822,395	770,004
Average:					
Loans	$ 7,464,140	$ 6,523,906	$ 5,594,477	$ 4,823,198	$ 4,497,489
Earning assets	11,339,876	10,202,981	8,968,906	8,352,334	8,011,081
Total assets	13,041,682	11,581,253	10,143,245	9,618,849	9,583,829
Non-interest-bearing demand deposits	3,524,132	3,334,280	3,008,750	2,914,520	3,037,724
Interest-bearing deposits	6,688,509	5,850,116	5,124,036	4,852,166	4,539,622
Total deposits	10,212,641	9,184,396	8,132,786	7,766,686	7,577,346
Long-term debt and other borrowings	413,700	405,752	387,612	363,386	264,428
Shareholders equity	1,395,022	1,073,599	880,640	789,073	733,994

Asset Quality										
Allowance for possible loan losses	$	92,339	$	96,085	$	80,325	$	75,810	$	83,501
Allowance for possible loan losses to period-end loans		1.19%		1.30%		1.32%		1.47%		1.82%
Net loan charge-offs	$	18,406	$	11,110	$	8,921	$	10,191	$	9,627
Net loan charge-offs to average loans		0.25%		0.17%		0.16%		0.20%		0.21%
Non-performing assets	$	29,849	$	57,749	$	38,927	$	39,116	$	52,794
Non-performing assets to:										
Total loans plus foreclosed assets		0.38%		0.78%		0.64%		0.76%		1.15%
Total assets		0.22		0.44		0.33		0.39		0.55
Consolidated Capital Ratios										
Tier 1 risk-based capital ratio		9.96%		11.25%		12.24%		12.83%		11.41%
Total risk-based capital ratio		12.59		13.43		14.94		15.99		15.01
Leverage ratio		8.37		9.56		9.62		9.18		7.83
Average shareholders equity to average total assets		10.70		9.27		8.68		8.20		7.66

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The following tables set forth unaudited consolidated selected quarterly statement of operations data for the years ended December 31, 2007 and 2006. Dollar amounts are in thousands, except per share data.

	Year Ended December 31, 2007			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
Interest income	$ 188,370	$ 194,874	$ 193,021	$ 192,582
Interest expense	57,610	64,250	63,501	64,749
Net interest income	130,760	130,624	129,520	127,833
Provision for possible loan losses	3,576	5,784	2,650	2,650
Non-interest income(1)	66,383	70,756	64,020	67,072
Non-interest expense	114,150	113,567	112,642	122,087
Income before income taxes	79,417	82,029	78,248	70,168
Income taxes	24,717	25,566	24,619	22,889
Net income	$ 54,700	$ 56,463	$ 53,629	$ 47,279
Net income per common share:				
Basic	$ 0.94	$ 0.97	$ 0.90	$ 0.79
Diluted	0.93	0.95	0.89	0.78

	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(2)	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

(1) Includes net gain on securities transactions of $15 thousand during the fourth quarter of 2007.

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

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

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

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

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

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

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

Inflation, interest rate, securities market and monetary fluctuations.

Political instability.

Acts of God or of war or terrorism.

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

Changes in consumer spending, borrowings and savings habits.

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

Technological changes.

Acquisitions and integration of acquired businesses.

The ability to increase market share and control expenses.

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

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

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

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

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

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

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

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

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

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

Accounting policies related to the allowance for possible loan losses are considered to be critical, as these policies involve considerable subjective judgment and estimation by management. 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, 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. 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.

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Overview

The following discussion and analysis presents the more significant factors affecting the Corporation s financial condition as of December 31, 2007 and 2006 and results of operations for each of the years in the three-year period ended December 31, 2007. 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. The Corporation acquired Prime Benefits, Inc. in 2007, Summit Bancshares, Inc. (Summit), Alamo Corporation of Texas (Alamo) and Texas Community Bancshares, Inc. (TCB) in 2006 and Horizon Capital Bank (Horizon) in 2005. 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 $212.1 million, or $3.55 diluted per common share, in 2007 compared to $193.6 million, or $3.42 diluted per common share, in 2006 and $165.4 million, or $3.07 diluted per common share, in 2005.

Selected income statement data, returns on average assets and average equity and dividends per share for the comparable periods were as follows:

	2007	2006	2005
Taxable-equivalent net interest income	$ 534,195	$ 479,138	$ 398,938
Taxable-equivalent adjustment	15,458	9,975	7,672
Net interest income	518,737	469,163	391,266
Provision for possible loan losses	14,660	14,150	10,250
Non-interest income	268,231	240,747	230,379
Non-interest expense	462,446	410,353	367,007
Income before income taxes	309,862	285,407	244,388
Income taxes	97,791	91,816	78,965
Net income	$ 212,071	$ 193,591	$ 165,423
Earnings per common share:			
Basic	$ 3.60	$ 3.49	$ 3.15

Diluted	3.55	3.42	3.07
Return on average assets	1.63%	1.67%	1.63%
Return on average equity	15.20	18.03	18.78

Net income for 2007 increased $18.5 million, or 9.5%, compared to 2006. The increase was primarily due to a $49.6 million increase in net interest income and a $27.5 million increase in non-interest income. The impact of these items was partly offset by a $52.1 million increase in non-interest expense, a $6.0 million increase in income tax expense and a $510 thousand increase in the provision for possible loan losses. 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.

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

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Net Interest Income

Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest income is the Corporation s largest source of revenue, representing 65.9% of total revenue during 2007. 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 2005 at 5.25% and 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%. During 2007, the prime interest rate decreased 50 basis points in the third quarter and 50 basis points in the fourth quarter to end the year at 7.25%. The federal funds rate, which is the cost of immediately available overnight funds, fluctuated in a similar manner. It began 2005 at 2.25% and 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%. During 2007, the federal funds rate decreased 50 basis points in the third quarter and 50 basis points in the fourth quarter to end the year at 4.25%.

The Corporation s balance sheet has historically been asset sensitive, meaning that earning assets generally reprice more quickly than interest-bearing liabilities. Therefore, the Corporation s net interest margin was likely to increase in sustained periods of rising interest rates and decrease in sustained periods of declining interest rates. In an effort to make the Corporation s balance sheet less sensitive to changes in interest rates, the Corporation entered into interest rate swaps during the fourth quarter of 2007 that effectively convert $1.2 billion of loans with floating interest rates tied to the prime rate into fixed rate loans for a period of seven years. See Note 17 Derivative Financial Instruments in the accompanying notes to consolidated financial statements included elsewhere in this report for additional information related to these interest rate swaps. As a result, the Corporations balance sheet is more interest-rate neutral and changes in interest rates are expected to have a less significant impact on the Corporation s net interest margin. The Corporation is primarily funded by core deposits, with non-interest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on the Corporation s net interest income and net interest margin in a rising interest rate environment. During January 2008, the federal funds rate and the prime interest rate each decreased 125 basis points to 3.00% and 6.00%, respectively. The Corporation currently believes it is reasonably possible the federal funds rate and the prime interest rate will decrease further in the foreseeable future; however, there can be no assurance to that effect or as to the magnitude of any decrease should a decrease occur, as changes in market interest rates are dependent upon a variety of factors that are beyond the Corporation s control. Further analysis of the components of the Corporation s net interest margin is presented below.

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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 116 and 117 of this report.

	2007 vs. 2006 Increase (Decrease) Due to Change in			2006 vs. 2005 Increase (Decrease) Due to Change in		
	Rate	Volume	Total	Rate	Volume	Total
Interest-bearing deposits	$ (44)	$ 189	$ 145	$ 155	$ (54)	$ 101
Federal funds sold and resell agreements	496	(7,151)	(6,655)	6,633	11,770	18,403
Securities:						
Taxable	6,417	8,866	15,283	4,474	7,333	11,807
Tax-exempt	(138)	8,973	8,835	(58)	1,222	1,164
Loans		72,763	72,763	66,202	78,758	144,960
Total earning assets	6,731	83,640	90,371	77,406	99,029	176,435
Savings and interest checking	1,520	456	1,976	1,221	349	1,570
Money market deposit accounts	914	14,497	15,411	28,660	15,257	43,917
Time accounts	6,709	10,749	17,458	11,088	11,219	22,307
Public funds	707	(405)	302	6,033	2,329	8,362
Federal funds purchased and repurchase agreements	(3,209)	3,993	784	6,709	7,826	14,535
Junior subordinated deferrable interest debentures	(471)	(5,648)	(6,119)	2,209	285	2,494
Subordinated notes payable and other notes	(152)	5,752	5,600	2,365		2,365
Federal Home Loan Bank advances	47	(145)	(98)	22	663	685
Total interest-bearing liabilities	6,065	29,249	35,314	58,307	37,928	96,235
Changes in taxable-equivalent net interest income	$ 666	$ 54,391	$ 55,057	$ 19,099	$ 61,101	$ 80,200

Taxable-equivalent net interest income for 2007 increased $55.1 million, or 11.5%, compared to 2006. The increase primarily resulted from an increase in the average volume of earning assets. The average volume of earning assets for

2007 increased $1.1 billion compared to 2006. Over the same time frame, the net interest margin increased 2 basis points from 4.67% in 2006 to 4.69% in 2007. The increase in the average volume of earning assets was due in part to the acquisition of Summit in 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 net interest margin was primarily due to an increase in the average yield on interest earning assets partly offset by an increase in the average cost of funds. The average yield on interest earning assets during 2007 was 6.89% compared to 6.76% during 2006. This increase was partly due to a 24 basis point increase in the average yield on securities. Furthermore, the Corporation had a larger proportion of average interest earning assets invested in higher-yielding loans during 2007 relative to 2006. During 2006, market interest rates rose during each of the first two quarters while the reductions in market rates during 2007 did not occur until the latter part the year. The positive impact of higher average market rates and the more favorable mix of interest earning assets on the net interest margin was partly offset by an increase in the average cost of funds compared to the increase in the average yield on interest-earning assets. The average cost of funds increased 8 basis points to 3.14% during 2007 from 3.06% during 2006.

The increase in cost of funds was partly due to an increase in the relative proportion of average interest-bearing deposits, particularly higher-cost money market and time deposits, to 65.5% of total average deposits during 2007 from 63.7% of total average deposits during 2006.

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 the acquisitions of TCB and Alamo during the first quarter of 2006 and Summit during the fourth quarter of 2006. 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.

The average volume of loans, the Corporation s primary category of earning assets, increased $940.2 million, or 14.4%, during 2007 compared to 2006 and increased $929.4 million, or 16.6%, during 2006 compared to 2005. The average yield on loans was 7.76% during both 2007 and 2006 and 6.46% during 2005. As stated above, the Corporation had a larger proportion of average earning assets invested in loans during both 2007 compared to 2006 and 2006 compared to 2005. Such investments have significantly higher yields compared to securities and federal funds sold and resell agreements and, as such, have a more positive effect on the net interest margin. The average volume of securities increased $332.2 million in 2007 compared to 2006 and increased $109.0 million in 2006 compared to 2005. The average yield on securities was 5.24% during 2007 compared to 5.00% during 2006 and 4.84% during 2005. The fluctuations in securities average balances during the comparable years were primarily in U.S. government agency securities and U.S. Treasury securities. Average federal funds sold and resell agreements decreased $139.0 million during 2007 compared to the 2006 and increased $197.3 million during 2006 compared to 2005. The average yield on federal funds sold and resell agreements was 5.15% during 2007 compared to 5.08% during 2006 and 3.48% during 2005.

Average deposits increased $1.0 billion during 2007 compared to 2006 and $1.1 billion in 2006 compared to 2005. The increase in the average volume of deposits during 2007 and 2006 was due in part to the acquisitions of TCB and Alamo during the first quarter of 2006 and Summit during the fourth quarter of 2006. The increase in average deposits over the comparable years was primarily in interest-bearing deposits. Average interest-bearing deposits increased $838.4 million during 2007 compared to 2006 and $726.1 million during 2006 compared to 2005. The ratio of average interest-bearing deposits to total average deposits was 65.5% during 2007 compared to 63.7% in 2006 and 63.0% in 2005. The average cost of interest-bearing deposits and total deposits was 2.84% and 1.86% during 2007 compared to 2.65% and 1.69% during 2006 and 1.54% and 0.97% during 2005. The increase in the average cost of interest-bearing deposits was primarily the result of increases in interest rates offered on deposit products due to higher average 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 3.75% in 2007 compared to 3.70% in 2006 and 3.83% in 2005. The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 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.

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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 $14.7 million in 2007 compared to $14.2 million in 2006 and $10.3 million in 2005. See the section captioned Allowance for Possible Loan Losses elsewhere in this discussion for further analysis of the provision for possible loan losses.

Non-Interest Income

The components of non-interest income were as follows:

	2007	2006	2005
Trust fees	$ 70,359	$ 63,469	$ 58,353
Service charges on deposit accounts	80,718	77,116	78,751
Insurance commissions and fees	30,847	28,230	27,731
Other charges, commissions and fees	32,558	28,105	23,125
Net gain (loss) on securities transactions	15	(1)	19
Other	53,734	43,828	42,400
Total	$ 268,231	$ 240,747	$ 230,379

Total non-interest income for 2007 increased $27.5 million, or 11.4%, compared to 2006 while total non-interest income for 2006 increased $10.4 million, or 4.5%, compared to 2005. Changes in the various components of non-interest income are discussed in more detail below.

Trust Fees. Trust fee income for 2007 increased $6.9 million, or 10.9%, compared to 2006 while trust fee income for 2006 increased $5.1 million, or 8.8%, compared to 2005. Investment fees are the most significant component of trust fees, making up approximately 71% of total trust fees in 2007 and approximately 70% in 2006 and 2005. 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 2007 compared to 2006 was primarily the result of increases in investment fees (up $5.7 million), real estate fees (up $545 thousand) and securities lending income (up $506 thousand). This increase was slightly offset by a decrease in oil and gas fees (down $104 thousand). The increases in investment fees were primarily due to higher equity valuations during 2007 compared to 2006 and growth in overall trust assets and the number of trust accounts.

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.

At December 31, 2007, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (41.2% of trust assets), equity securities (39.3% of trust assets) and cash equivalents (12.7% of trust assets). The estimated fair value of trust assets was $24.8 billion (including managed assets of $10.5 billion and custody assets of $14.3 billion) at December 31, 2007 compared to $23.2 billion (including managed assets of $9.3 billion and custody assets of $13.9 billion) at December 31, 2006 and $18.1 billion (including managed assets of $8.3 billion and custody assets of $9.8 billion) at December 31, 2005.

Service Charges on Deposit Accounts. Service charges on deposit accounts for 2007 increased $3.6 million, or 4.7%, compared to 2006. Increases in overdraft/insufficient funds charges on consumer accounts (up $4.4 million) and commercial accounts (up $1.7 thousand) were partly offset by decreases in service charges on commercial accounts (down $2.4 million) and consumer accounts (down $728 thousand). The increases in overdraft/insufficient funds charges on both commercial and consumer accounts were partly the result of growth in deposit accounts and an increase in the per-occurrence fee charged. 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 is the value given to deposits maintained by treasury management customers. Because average interest rates were higher compared to 2006, deposit balances became more valuable and yielded a higher earnings credit rate. As a result, customers were able to pay for more of their services with earning credits applied to their deposit balances rather than through fees.

Service charges on deposit accounts for 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 primarily resulting from a higher earnings credit rate. 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.

Insurance Commissions and Fees. Insurance commissions and fees for 2007 increased $2.6 million, or 9.3%, compared to 2006. The increase was primarily related to higher commission income (up $2.0 million) and an increase in contingent commissions (up $567 thousand). 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 include contingent commissions totaling $3.7 million during 2007 compared to $3.1 million during 2006 and $3.4 million during 2005. 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 $3.3 million during 2007 and $2.8 million during both 2006 and 2005. Contingent commissions also include amounts received from various benefit plan insurance companies related to the volume of business generated and/or the subsequent retention of such business. These commissions totaled $366 thousand, $376 thousand and $584 thousand during 2007, 2006 and 2005.

Other Charges, Commissions and Fees. Other charges, commissions and fees for 2007 increased $4.5 million, or 15.8%, compared to 2006. The increase was primarily related to increases in commission income related to the sale of money market accounts (up $1.3 million) and mutual funds (up $898 thousand). The Corporation also recognized account management fees totaling $1.3 million related to a line of business acquired in connection with the acquisition of Summit during the fourth quarter of 2006.

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.

Net Gain/Loss on Securities Transactions. During 2007, the Corporation realized a net gain on securities transactions of $15 thousand related to the sales of available-for-sale securities with an amortized cost totaling $64.9 million. 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.

Other Non-Interest Income. Other non-interest income increased $9.9 million, or 22.6%, during 2007 compared to 2006. Contributing to the increase during 2007 were increases in sundry income from various miscellaneous items (up $3.3 million), income from check card usage (up $3.0 million), lease rental income (up $1.4 million), gains on the sales of foreclosed and other assets (up $1.2 million) and income from securities trading and customer derivative activities (up $872 thousand). These increases were partly offset by decreases in gains on the sales of student loans (down $1.0 million) and mineral interest income (down $570 thousand). During 2007 significant components of sundry income included $2.4 million in income recognized from the collection of interest and other charges on loans charged-off in prior years and $1.2 million in income recognized in connection with settlements and other recoveries.

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).

Non-Interest Expense

The components of non-interest expense were as follows:

	2007	2006	2005
Salaries and wages	$ 209,982	$ 190,784	$ 166,059
Employee benefits	47,095	46,231	41,577
Net occupancy	38,824	34,695	31,107
Furniture and equipment	32,821	26,293	23,912
Intangible amortization	8,860	5,628	4,859
Other	124,864	106,722	99,493
Total	$ 462,446	$ 410,353	$ 367,007

Total non-interest expense for 2007 increased $52.1 million, or 12.7%, compared to 2006 while total non-interest expense for 2006 increased $43.3 million, or 11.8%, compared to 2005. Changes in the various components of non-interest expense are discussed below.

Salaries and Wages. Salaries and wages for 2007 increased $19.2 million, or 10.1%, compared to 2006. The increase was primarily related to normal, annual merit increases, an increase in headcount and an increase in commissions related to higher insurance revenues. The increases in headcount were primarily related the acquisitions of TCB and Alamo during the first quarter of 2006 and Summit during the fourth quarter of 2006.

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 acquisitions of Horizon during the fourth quarter of 2005, TCB and Alamo during the first quarter of 2006 and 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.

Employee Benefits. Employee benefits expense for 2007 increased $864 thousand, or 1.9%, compared to 2006. The increase was primarily related to increases in expenses related to the Corporation s 401(k) and profit sharing plans (up $3.5 million) and payroll taxes (up $943 thousand). These increases were partially offset by decreases in medical costs (down $2.1 million), workers compensation insurance cost (down $834 thousand) and expenses related to the Corporation s defined benefit retirement and restoration plans (down $778 thousand). The decrease in medical expense was primarily related to a decrease in certain accruals for medical expense as a result of lower projected medical costs. The decrease in workers compensation insurance expense was primarily related to a reversal in certain related accruals based on current projected costs.

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 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 $1.9 million in 2007, $2.7 million in 2006 and $1.9 million in 2005. 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 2007 increased $4.1 million, or 11.9%, compared to 2006. The increase was primarily due to an increase in lease expense (up $1.7 million), service contracts expense (up $517 thousand), property tax expense (up $513 thousand), utilities expense (up $422 thousand) and building maintenance (up $382 thousand). These increases were partly related to the additional facilities added in connection with the acquisitions of TCB and Alamo during the first quarter of 2006 and Summit during the fourth quarter of 2006.

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 the acquisitions of Horizon during the fourth quarter of 2005, TCB and Alamo during the first quarter of 2006 and Summit during the fourth quarter of 2006.

Furniture and Equipment. Furniture and equipment expense for 2007 increased $6.5 million, or 24.8%, compared to 2006. The increase was primarily related to increases in software maintenance expense (up $2.9 million), depreciation expense related to furniture and fixtures (up $1.7 million), software amortization expense (up $1.1 million) and service contracts expense (up $596 thousand). The increases in various furniture and equipment expenses were partly related to the acquisitions of TCB and Alamo during the first quarter of 2006 and Summit during the fourth quarter of 2006. Additionally, the Corporation entered into software maintenance contracts in connection with new operating platforms related to retail delivery during the second quarter of 2007.

Furniture and equipment expense for 2006 increased $2.4 million, or 10.0%, compared to 2005. The increase was primarily due to i