INTERNATIONAL BANCSHARES CORP
Form 10-Q
November 08, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

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 0-9439

INTERNATIONAL BANCSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Texas	**74-2157138**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1200 San Bernardo Avenue, Laredo, Texas 78042-1359

(Address of principal executive offices)

(Zip Code)

(956) 722-7611

(Registrant s telephone number, including area code)

None

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

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

Indicate by check mark if 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.

Large Accelerated Filer x 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 Exchange Act). Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Shares Issued and Outstanding**
Common Stock, $1.00 par value	63,011,003 shares outstanding at October 31, 2006

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition (Unaudited)

(Dollars in Thousands)

	September 30, 2006	December 31, 2005
Assets		
Cash and due from banks	$ 219,785	$ 216,118
Federal funds sold	42,000	242,000
Total cash and cash equivalents	261,785	458,118
Time deposits with banks	396	396
Investment securities:		
Held-to-maturity (Market value of $2,375 on September 30, 2006 and December 31, 2005)	2,375	2,375
Available-for-sale (Amortized cost of $4,458,507 on September 30, 2006 and $4,331,517 on December 31, 2005)	4,380,154	4,266,952
Total investment securities	4,382,529	4,269,327
Loans, net of unearned discounts	4,910,827	4,625,692
Less allowance for possible loan losses	(64,933)	(77,796)
Net loans	4,845,894	4,547,896
Bank premises and equipment, net	387,135	351,986
Accrued interest receivable	54,999	48,647
Other investments	339,436	332,675
Identified intangible assets, net	35,574	39,224
Goodwill, net	282,246	289,262
Other assets	100,332	54,322
Total assets	$ 10,690,326	$ 10,391,853

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	September 30, 2006	December 31, 2005
Liabilities and Shareholders Equity		
Liabilities:		
Deposits:		
Demand non-interest bearing	$ 1,372,642	$ 1,339,380
Savings and interest bearing demand	2,062,305	2,156,234
Time	3,280,215	3,160,812
Total deposits	6,715,162	6,656,426
Securities sold under repurchase agreements	620,914	760,762
Other borrowed funds	2,166,872	1,870,075
Junior subordinated deferrable interest debentures	210,801	236,391
Other liabilities	151,716	75,332
Total liabilities	9,865,465	9,598,986
Shareholders equity:		
Common shares of $1.00 par value. Authorized 275,000,000 shares; issued 86,188,907 shares on September 30, 2006 and 86,059,121 shares on December 31, 2005	86,189	86,059
Surplus	137,666	135,619
Retained earnings	851,529	788,416
Accumulated other comprehensive loss	(50,929)	(41,968)
	1,024,455	968,126
Less cost of shares in treasury, 23,193,366 shares on September 30, 2006 and 22,330,354 shares on December 31, 2005	(199,594)	(175,259)
Total shareholders equity	824,861	792,867
Total liabilities and shareholders equity	$ 10,690,326	$ 10,391,853

See accompanying notes to consolidated financial statements.

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INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended September 30, 2006	**2005**	**Nine Months Ended September 30, 2006**	**2005**
Interest income:				
Loans, including fees	$ 104,837	$ 86,304	$ 292,441	$ 250,974
Federal funds sold	748	1,079	2,942	2,433
Investment securities:				
Taxable	49,728	41,274	149,094	116,965
Tax-exempt	1,136	1,209	3,452	3,646
Other interest income	103	102	315	429
Total interest income	156,552	129,968	448,244	374,447
Interest expense:				
Savings deposits	9,743	7,335	28,786	18,970
Time deposits	32,759	18,959	88,379	50,041
Securities sold under repurchase agreements	7,319	7,219	22,867	19,758
Other borrowings	29,423	16,403	74,157	41,836
Junior subordinated interest deferrable debentures	7,356	4,829	17,741	13,547
Total interest expense	86,600	54,745	231,930	144,152
Net interest income	69,952	75,223	216,314	230,295
Provision for possible loan losses	1,954	(196)	2,633	2,635
Net interest income after provision for possible loan losses	67,998	75,419	213,681	227,660
Non-interest income:				
Service charges on deposit accounts	21,324	21,857	63,839	62,761
Other service charges, commissions and fees				
Banking	7,451	6,094	21,680	18,372
Non-banking	6,000	3,241	14,011	7,352
Loss on investment securities transactions, net	(1,353)		(943)	(181)
Other investments, net	3,389	3,802	15,346	11,665
Other income	3,247	5,889	13,764	20,644
Total non-interest income	40,058	40,883	127,697	120,613

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Non-interest expense:				
Employee compensation and benefits	$ 31,418	$ 28,518	$ 91,042	$ 84,288
Occupancy	6,919	6,269	19,667	17,655
Depreciation of bank premises and equipment	7,201	6,657	21,006	18,464
Professional fees	2,819	2,869	8,289	9,088
Stationery and supplies	1,568	1,297	4,469	4,048
Amortization of identified intangible assets	1,217	1,298	3,650	3,895
Advertising	2,891	2,996	8,935	8,404
Other	14,995	14,716	58,547	43,791
Total non-interest expense	69,028	64,620	215,605	189,633
Income before income taxes	39,028	51,682	125,773	158,640
Provision for income taxes	12,435	16,214	40,547	52,140
Net income	$ 26,593	$ 35,468	$ 85,226	$ 106,500
Basic earnings per common share:				
Weighted average number of shares outstanding:	62,988,619	63,689,160	63,188,534	63,689,914
Net income	$ .42	$ .56	$ 1.35	$ 1.67
Fully diluted earnings per common share:				
Weighted average number of shares outstanding:	63,616,264	64,419,413	63,841,275	64,502,333
Net income	$ .42	$ .55	$ 1.33	$ 1.65

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in Thousands)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net income	$ 26,593	$ 35,468	$ 85,226	$ 106,500
Other comprehensive income (loss), net of tax				
Unrealized holding gains (losses) on securities arising during period, net of reclassification adjustment for gains included in net income	14,054	(8,166)	(8,961)	(28,433)
Comprehensive income	$ 40,647	$ 27,302	$ 76,265	$ 78,067

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in Thousands)

	Nine Months Ended September 30, 2006	2005
Operating activities:		
Net income	$ 85,226	$ 106,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for possible loan losses	2,633	2,635
Amortization of loan premiums	965	1,034
Accretion of time deposit discounts		(5,391)
Depreciation of bank premises and equipment	21,006	18,464
Gain on sale of bank premises and equipment	(487)	(158)
Depreciation and amortization of leased assets	1,625	1,425
Accretion of investment securities discounts	(334)	(461)
Amortization of investment securities premiums	3,075	19,307
Investment securities transactions, net	943	181
Amortization of junior subordinated debenture discounts	441	769
Amortization of identified intangible assets	3,650	3,895
Stock based compensation expense	689	
Earnings from affiliates and other investments	(8,772)	(8,733)
Deferred tax expense	616	5,341
Increase in accrued interest receivable	(6,352)	(5,185)
Net (increase) decrease in other assets	(47,635)	5,270
Net increase in other liabilities	87,610	25,280
Net cash provided by operating activities	144,899	170,173
Investing activities:		
Proceeds from maturities of securities	5,270	4,366
Proceeds from sales of available for sale securities	61,360	189,187
Purchases of available for sale securities	(851,186)	(1,273,486)
Principal collected on mortgage-backed securities	653,314	666,805
Principal collected on other securities	568	
Net (increase) decrease in loans	(301,596)	170,636
Distributions (purchases) of other investments	2,012	(15,862)
Purchases of bank premises and equipment	(65,165)	(55,879)
Proceeds from sale of bank premises and equipment	9,497	504
Net cash used in investing activities	(485,926)	(313,729)

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	Nine Months Ended September 30, 2006	2005
Financing activities:		
Net increase in non-interest bearing demand deposits	$ 33,262	$ 147,251
Net decrease in savings and interest bearing demand deposits	(93,929)	(109,026)
Net increase (decrease) in time deposits	119,403	(113,311)
Net (decrease) increase in securities sold under repurchase agreements	(139,848)	144,744
Proceeds from issuance of other borrowed funds	4,538,687	3,105,000
Principal payments on other borrowed funds	(4,241,890)	(2,850,123)
Proceeds of issuance of long-term debt	41,238	
Principal payments of long term-debt	(67,269)	
Purchase of treasury stock	(24,335)	(8,584)
Proceeds from stock transactions	1,488	4,670
Payment of cash dividends	(22,113)	(20,423)
Payment of cash dividends in lieu of fractional shares		(25)
Net cash provided by financing activities	144,694	300,173
(Decrease) increase in cash and cash equivalents	(196,333)	156,617
Cash and cash equivalents at beginning of period	458,118	195,770
Cash and cash equivalents at end of period	$ 261,785	$ 352,387
Supplemental cash flow information:		
Interest paid	$ 226,301	$ 136,742
Income taxes paid	38,231	39,017
Adjustment to goodwill arising from acquisition	7,016	

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

Note 1 - Basis of Presentation

The accounting and reporting policies of International Bancshares Corporation (Corporation) and Subsidiaries (the Corporation and Subsidiaries collectively referred to herein as the Company) conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries, International Bank of Commerce, Laredo (IBC), Commerce Bank, International Bank of Commerce, Zapata, International Bank of Commerce, Brownsville and the Corporation s wholly-owned non-bank subsidiaries, IBC Subsidiary Corporation, IBC Life Insurance Company, IBC Trading Company, and IBC Capital Corporation, as well as the GulfStar Group in which the Company owns a controlling interest. All significant inter-company balances and transactions have been eliminated in consolidation. The consolidated financial statements are unaudited, but include all adjustments, which, in the opinion of management, are necessary for a fair presentation of the results of the periods presented. All such adjustments were of a normal and recurring nature. It is suggested that these financial statements be read in conjunction with the financial statements and the notes thereto in the Company s latest Annual Report on Form 10-K. The consolidated statement of condition at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Certain reclassifications have been made to make prior periods comparable.

The Company operates as one segment. The operating information used by the Company s chief executive officer for purposes of assessing performance and making operating decisions about the Company is the consolidated statements presented in this report. The Company has four active operating subsidiaries, namely, the bank subsidiaries, otherwise known as International Bank of Commerce, Laredo, Commerce Bank, International Bank of Commerce, Zapata and International Bank of Commerce, Brownsville. The Company applies the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, in determining its reportable segments and related disclosures. None of the Company s other subsidiaries meets the 10% threshold for disclosure under SFAS No. 131.

All per share data presented has been restated to reflect the stock splits effected through stock dividends, Note 8.

Note 2 Loans

A summary of net loans, by loan type at September 30, 2006 and December 31, 2005 is as follows:

	September 30, 2006 (Dollars in thousands)	December 31, 2005
Commercial, financial and agricultural	$ 2,360,216	$ 2,376,276
Real estate-mortgage	781,950	847,512
Real estate construction	1,260,454	901,518
Consumer	197,161	218,607
Foreign	311,128	281,947
Total loans	4,910,909	4,625,860
Unearned discount	(82)	(168)
Loans, net of unearned discount	$ 4,910,827	$ 4,625,692

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Note 3 Stock Options

On April 1, 2005, the Board of Directors adopted the 2005 International Bancshares Corporation Stock Option Plan (the 2005 Plan). The 2005 Plan replaced the 1996 International Bancshares Corporation Key Contributor Stock Option Plan (the 1996 Plan). Under the 2005 Plan both qualified incentive stock options (ISOs) and non-qualified stock options (NQSOs) may be granted. Options granted may be exercisable for a period of up to 10 years from the date of grant, excluding ISOs granted to 10% shareholders, which may be exercisable for a period of up to only five years. As of September 30, 2006, 95,950 shares were available for future grants under the 2005 Plan.

Through September 30, 2006, the Company has granted non-qualified stock options exercisable for a total of 167,847 shares, adjusted for stock dividends, of Common Stock to certain employees of the GulfStar Group. The grants were not made under either the 1996 Plan or the 2005 Plan. The options are exercisable for a period of seven years and vest in equal increments over a period of five years. All options granted to the GulfStar Group employees had an option price of not less than the fair market value of the Common Stock on the date of grant.

On January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R, (SFAS No. 123R), Share-Based Payment, (Revised 2004). SFAS No. 123R sets accounting requirements for share-based compensation to employees and non-employee directors, including employee stock purchase plans, and requires companies to recognize in the statement of operations the grant-date fair value of stock options and other equity-based compensation.

The Company chose the modified-prospective transition alternative in adopting SFAS 123R. Under the modified-prospective transition method, compensation cost is recognized in financial statements issued subsequent to the date of adoption for all stock-based payments granted, modified or settled after the date of adoption, as well as for any unvested awards that were granted prior to the date of adoption.

The fair value of each option award is estimated on the date of grant using a Black-Scholes-Merton option valuation model that uses the assumptions noted in the following table. Expected volatility is based on the historical volatility of the price of the Company s stock. The Company uses historical data to estimate the expected dividend yield and employee termination rates within the valuation model. The expected term of options is derived from the simplified method as prescribed by SEC Staff Accounting Bulletin No. 107. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	Nine Months Ended September 30, 2006		**2005**	
Expected term (in years)	6.13		5.5	
Expected stock price volatility	21	%	25	%
Expected dividend yield	2.25	%	2.5	%
Forfeiture rate	10	%	10	%
Risk free interest rate	5.13	%	3.72	%

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A summary of option activity under the stock option plans for the nine months ended September 30, 2006 is as follows:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value ($)
Options outstanding at December 31, 2005	1,626,155	$ 16.55		
Plus: Options granted	15,000	29.40		
Less:				
Options exercised	129,786	11.46		
Options expired				
Options forfeited	45,008	26.69		
Options outstanding at September 30, 2006	1,466,361	$ 16.82	3.06	$ 18,918,000
Options fully vested and exercisable at September 30, 2006	1,047,223	$ 12.22	1.60	$ 18,331,000

Stock-based compensation expense included in the consolidated statements of income for the nine months ended September 30, 2006 was approximately $689,000. As of September 30, 2006 there was approximately $1,927,000, of total unrecognized stock-based compensation cost related to non-vested options granted under the Company plans that will be recognized over a weighted average period of 1.9 years.

A summary of the status of the Company s non-vested options as of September 30, 2006, and changes during the nine months ended September 30, 2006, is presented below:

Non-vested Options	Options	Weighted average grant-date fair value ($)
Non-vested options at December 31, 2005	546,845	$ 7.52
Granted	15,000	7.12
Vested	97,699	8.18
Forfeited	45,008	7.58
Non-vested options at September 30, 2006	419,138	$ 7.41

Other information pertaining to option activity during the nine month period ending September 30, 2006 and September 30, 2005 is as follows:

	Nine Months Ended September 30, 2006	2005
Weighted average grant date fair value of stock options granted	$ 7.12	$ 8.76
Total fair value of stock options vested	$ 799,500	$ 980,518
Total intrinsic value of stock options exercised	$ 2,270,000	$ 7,459,000

Awards granted prior to the Company s adoption of SFAS No. 123R were accounted for under the recognition and measurement principles of APB Opinion 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no stock-based employee compensation cost is reflected in net income in the accompanying unaudited consolidated statements of income for the three and nine months ended September 30, 2005 because all options granted under the Company s plans had exercise prices equal to the market value of the underlying common stock on the date of grant.

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Pro forma net income and net income per share, as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation for the period presented prior to the Company s adoption of SFAS 123R is as follows:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
	(Dollars in Thousands, except per share data)	
Net income, as reported	$ 35,468	$ 106,500
Deduct: Total stock-based compensation expense determined under the fair value based method for all awards, net of tax related tax effects	(52)	(191)
Pro forma net income	$ 35,416	$ 106,309
Earnings per share:		
Basic earnings		
As reported	$ .56	$ 1.67
Pro forma	.56	1.67
Diluted earnings		
As reported	$ .55	$ 1.65
Pro forma	.55	1.65

Note 4 Investment Securities

The Company classifies debt and equity securities into one of three categories: held-to maturity, available-for-sale, or trading. Such classifications are reassessed for appropriate classification at each reporting date. Securities classified as held-to-maturity are carried at amortized cost for financial statement reporting, while securities classified as available-for-sale and trading are carried at their fair value. Unrealized holding gains and losses are included in net income for those securities classified as trading , while unrealized holding gains and losses related to those securities classified as available-for-sale are excluded from net income and reported net of tax as other comprehensive income (loss) and accumulated other comprehensive income (loss) until realized.

A summary of the investment securities held for investment and securities available for sale as reflected on the books of the Company is as follows:

	September 30, 2006	December 31, 2005
	(Dollars in Thousands)	
U.S. Treasury securities		
Available-for-sale	$ 1,278	$ 1,298
Mortgage-backed securities		
Available-for-sale	4,267,014	4,148,844
States and political subdivisions		
Available-for-sale	95,565	99,557
Other		
Held-to-maturity	2,375	2,375
Available-for-sale	16,297	17,253
Total investment securities	$ 4,382,529	$ 4,269,327

Note 5 Allowance for Possible Loan Losses

A summary of the transactions in the allowance for possible loan losses is as follows:

	September 30, 2006 (Dollars in Thousands)	September 30, 2005
Balance at December 31,	$ 77,796	$ 81,351
Losses charged to allowance	(16,387)	(5,062)
Recoveries credited to allowance	891	1,875
Net losses charged to allowance	(15,496)	(3,187)
Provision charged to operations	2,633	2,635
Balance at September 30,	$ 64,933	$ 80,799

Impaired loans are those loans where it is probable that all amounts due according to contractual terms of the loan agreement will not be collected. The Company has identified these loans through its normal loan review procedures. Impaired loans are measured based on (1) the present value of expected future cash flows discounted at the loan s effective interest rate; (2) the loan s observable market price; or (3) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company s impaired loans are measured at the fair value of the collateral. In limited cases, the Company may use other methods to determine the level of impairment of a loan if such loan is not collateral dependent.

The following table details key information regarding the Company s impaired loans:

	September 30, 2006 (Dollars in Thousands)	December 31, 2005
Balance of impaired loans where there is a related allowance for loan loss	$ 21,544	$ 34,796
Balance of impaired loans where there is no related allowance for loan loss		
Total impaired loans	$ 21,544	$ 34,796
Allowance allocated to impaired loans	$ 7,482	$ 20,014

The impaired loans included in the table above were primarily comprised of collateral dependent commercial loans, which have not been fully charged off. The average recorded investment in impaired loans was $28,589,000 and $29,909,000 for September 30, 2006 and December 31, 2005, respectively. The interest recognized on impaired loans was not significant. The majority in losses charged to the allowance can be attributed to charges related to loans acquired from the purchase of Local Financial Corporation (LFIN).

Management of the Company recognizes the risks associated with these impaired loans. However, management s decision to place loans in this category does not necessarily mean that losses will occur.

The bank subsidiaries charge off that portion of any loan which management considers to represent a loss as well as that portion of any other loan which is classified as a loss by bank examiners. Commercial and industrial or real estate loans are generally considered by management to represent a loss, in whole or part, when an exposure beyond any collateral coverage is apparent and when no further collection of the loss portion is anticipated based on the borrower s financial condition and general economic conditions in the borrower s industry. Generally, unsecured consumer loans are charged-off when 90 days past due.

While management of the Company considers that it is generally able to identify borrowers with financial problems reasonably early and to monitor credit extended to such borrowers carefully, there is no precise method of predicting loan losses. The determination that a loan is likely to be uncollectible and that it should be wholly or partially charged-off as a loss is an exercise of judgment. Similarly, the determination of the adequacy of the allowance for possible loan losses can be made only on a subjective basis. It is the judgment of the Company s management that the allowance for possible loan losses at September 30, 2006 was adequate to absorb probable losses from loans in the portfolio at that date.

Note 6 Other Borrowed Funds

Other borrowed funds include Federal Home Loan Bank borrowings, which are short or long term, variable or fixed borrowings issued by the Federal Home Loan Bank of Dallas at the market price offered at the time of funding. These borrowings are secured by mortgage-backed investment securities and a portion of the Company s loan portfolio. At September 30, 2006, other borrowed funds totaled $2,166,872,000, an increase of 15.9% from $1,870,075,000 at December 31, 2005.

Note 7 Junior Subordinated Interest Deferrable Debentures

The Company has formed nine statutory business trusts under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. As part of the LFIN acquisition, the Company acquired three additional statutory business trusts previously formed by LFIN for the purpose of issuing trust preferred securities. The nine statutory business trusts formed by the Company and the three business trusts acquired in the LFIN transaction (the Trusts) have each issued Capital and Common Securities and invested the proceeds thereof in an equivalent amount of junior subordinated debentures (the Debentures) issued by the Company or LFIN, as appropriate. The Company has succeeded to the obligations of LFIN under the LFIN Debentures, which have an outstanding principal balance of $20,620,000. The Debentures will mature on various dates; however the Debentures may be redeemed at specified prepayment prices, in whole or in part after the optional redemption dates specified in the respective indentures or in whole upon the occurrence of any one of certain legal, regulatory or tax events specified in respective indentures. As of September 30, 2006, the principal amount of debentures outstanding totaled $210,801,000.

On July 25, 2006, pursuant to the Indenture dated as of July 16, 2001, between the Company and The Bank of New York, as Trustee, the Company redeemed all of its Floating Rate Junior Subordinated Debt Securities (the Debt Securities), issued to International Bancshares Capital Trust II (Trust II) at a redemption price equal to approximately $27,998,000, which includes accrued interest to but not including the redemption date.

In accordance with the Amended and Restated Declaration of Trust dated as of July 16, 2001 between the Company and The Bank of New York as Institutional Trustee, the proceeds from the redemption of the Debt Securities were used to simultaneously redeem an equal amount of Trust II Floating Capital Securities and the Trust II Floating Rate Common Securities issued by Trust II.

On September 30, 2006, pursuant to the Indenture dated as of September 20, 2001, between Local Financial Corporation and The Bank of New York, as Trustee, the Company redeemed all of its Floating Rate Junior Subordinated Debt Securities (the Debt Securities), issued to Local Financial Capital Trust I (LFIN Trust I) at a redemption price equal to approximately $41,155,625, which includes accrued interest to but not including the redemption date.

In accordance with the Amended and Restated Declaration of Trust dated as of September 20, 2001 between Local Financial Capital Corporation and The Bank of New York as Institutional Trustee, the proceeds from the redemption of the Debt Securities were used to simultaneously redeem an equal amount of LFIN Trust I Fixed Rate Capital Securities and the LFIN Trust I Fixed Rate Common Securities issued by LFIN Trust I.

On June 9, 2006, the Company formed International Bancshares Corporation Capital Trust IX (Trust IX), its ninth statutory business trust formed under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. On July 27, 2006, Trust IX issued $40,000,000 of Capital Securities. The Capital Securities accrue interest for the first five years at a fixed rate of 7.10%, and subsequently at a floating rate of 1.62% over the London Interbank Offered Rate (LIBOR), and interest is payable quarterly beginning October 1, 2006. The Trust IX Capital Securities will mature on October 1, 2036; however, the Capital Securities may be redeemed at specified prepayment prices (a) in whole or in part on any interest payment date on or after October 1, 2011, or (b) in whole or within 90 days upon the occurrence of certain legal, regulatory, or tax events. The Capital Securities are subordinated and junior in right of payment to all present and future senior indebtedness of the Company. The Company has fully and unconditionally guaranteed the obligation of Trust IX with respect to the Capital Securities. The Company has the right, unless an Event of Default has occurred and is continuing, to defer payment of interest on the Capital Securities for up to twenty consecutive quarterly periods. The redemption prior to maturity of any of the Capital Securities may require the prior approval of the Federal Reserve and/or other regulatory agencies.

In March 2005, the Federal Reserve Board issued a final rule that would continue to allow the inclusion of trust preferred securities in Tier 1 capital, but with stricter quantitative limits. Under the final rule, after a transition period ending March 31, 2009, the aggregate amount of trust preferred securities and certain other capital elements would be limited to 25% of Tier 1 capital elements, net of goodwill, less any associated deferred tax liability. The amount of trust preferred securities and certain other elements in excess of the limit could be included in Tier 2 capital, subject to restrictions. Bank holding companies with significant international operations will be expected to limit trust preferred securities to 15% of Tier 1 capital elements, net of goodwill; however, they may include qualifying mandatory convertible preferred securities up to the 25% limit. The Company believes that substantially all of the current trust preferred securities will be included in Tier 1 capital after the five-year transition period ending March 31, 2009.

The following table illustrates key information about each of the Capital and Common Securities and their interest rate at September 30, 2006:

	Junior Subordinated Deferrable Interest Debentures (in thousands)		Repricing Frequency	Interest Rate		Interest Rate Index	Maturity Date	Optional Redemption Date
Trust I	$	10,243	Fixed	10.18	%	Fixed	June 2031	June 2011
Trust III	$	34,021	Semi-Annually	9.17	%	LIBOR + 3.75	December 2031	December 2006
Trust IV	$	22,682	Semi-Annually	8.99	%	LIBOR + 3.70	April 2032	April 2007
Trust V	$	20,529	Quarterly	9.16	%	LIBOR + 3.65	July 2032	July 2007
Trust VI	$	25,624	Quarterly	8.86	%	LIBOR + 3.45	November 2032	November 2007
Trust VII	$	10,310	Quarterly	8.74	%	LIBOR + 3.25	April 2033	April 2008
Trust VIII	$	25,534	Quarterly	8.56	%	LIBOR + 3.05	October 2033	October 2008
Trust IX	$	41,238	Quarterly	7.10	%	Fixed	October 2036	October 2011
LFIN Trust II	$	10,310	Semi-Annually	9.17	%	LIBOR + 3.625	July 2032	July 2007
LFIN Trust III	$	10,310	Quarterly	8.86	%	LIBOR + 3.45	November 2032	November 2007
	$	210,801						

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Note 8 Common Stock and Dividends

All per share data presented has been restated to reflect the stock split effected through a stock dividend, which became effective May 2, 2005 and was paid on May 28, 2005. Cash dividends of $.35 per share were paid on May 1, 2006 and on November 1, 2006 to all holders of record on April 17, 2006 and October 16, 2006, respectively.

The Company expanded its formal stock repurchase program on March 9, 2006. Under the expanded stock repurchase program, the Company is authorized to repurchase up to $200,000,000 of its common stock through December 2006. Stock repurchases may be made from time to time, on the open market or through private transactions. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee stock option plans. As of October 31, 2006, a total of 4,824,411 shares had been repurchased under this program at a cost of $178,201,000. Stock repurchases are reviewed quarterly at the Company s Board of Directors meetings and the Board of Directors has stated that the aggregate investment in treasury stock should not exceed $220,973,000. In the past, the Board of Directors has increased previous caps on treasury stock once they were met, but there are no assurances that an increase of the $220,973,000 cap will occur in the future. As of October 31, 2006, the Company has approximately $199,174,000 invested in treasury shares, which amount has been accumulated since the inception of the Company.

Note 9 Commitments and Contingent Liabilities

The Company is involved in various legal proceedings that are in various stages of litigation. Some of these actions allege lender liability claims on a variety of theories and claim actual and punitive damages. The Company has determined, based on discussions with its counsel that any loss in such actions, individually or in the aggregate, is remote or the damages sought, even if fully recovered, would not be considered material to the consolidated financial position or results of operations of the Company. However, many of these matters are in various stages of proceedings and further developments could cause management to revise its assessment of these matters.

The Company s lead bank subsidiary has invested in partnerships, which have entered into several lease-financing transactions. The lease-financing transactions in two of the partnerships have been examined by the Internal Revenue Service (IRS). In both partnerships, the lead bank subsidiary was the owner of a ninety-nine percent (99%) limited partnership interest. The IRS has issued separate Notice of Final Partnership Administrative Adjustments (FPAA) to the partnerships and on September 25, 2001, and January 10, 2003, the Company filed lawsuits contesting the adjustments asserted in the FPAAs.

Prior to filing the lawsuits the Company was required to deposit the estimated tax due of approximately $4,083,000 with respect to the first FPAA and $7,710,606 with respect to the second FPAA with the IRS pursuant to the Internal Revenue Code. If it is determined that the amount of tax due, if any, related to the lease-financing transactions is less than the amount of the deposits, the remaining amount of the deposits would be returned to the Company.

In order to curtail the accrual of additional interest related to the disputed tax benefits and because interest rates were unfavorable, on March 7, 2003, the Company submitted to the IRS a total of approximately $13.7 million, which constitutes the interest that would have accrued based on the adjustments proposed in the FPAAs related to both of the lease-financing transactions. If it is determined that the amount of interest due, if any, related to the lease-financing transactions is less than the approximate $13.7 million, the remaining amount of the prepaid interest would be refunded to the Company, plus interest thereon.

Beginning August 29, 2005, IBC proceeded to litigate one of the partnership tax cases in the Federal District Court in San Antonio, Texas. On March 31, 2006, the trial court rendered a judgment against the Company on the first FPAA.

The Company, through December 31, 2005, had previously expensed approximately $12,000,000 in connection with the lawsuits. Because of the above-referenced trial court judgment against the Company on the first FPAA, the uncertainty of the outcome at the appellate level, and the similarity between the two FPAAs, the Company, as of September 30, 2006, has expensed an additional $13,700,000, approximately. The resultant approximately $25,700,000 expensed is the total of the tax adjustments due and the interest due on such adjustments for both FPAAs. Management intends to appeal the judgment in the first case and will continue to evaluate the merits of each lawsuit and make any appropriate revisions to the amounts, as deemed necessary.

As part of the LFIN acquisition, two tax matters were transferred to the Company. The first relates to deductions taken on amended returns filed by LFIN during 2003 for the tax years ended June 30, 1999 through December 31, 2001. The refunds requested on the amended returns amounted to approximately $7,000,000. At December 31, 2003, LFIN had received approximately $2,000,000 of the total refund requested. Because all the refunds are under review by the IRS, LFIN had established a reserve equal to the $2,000,000 received and did not recognize any benefit for the remaining $5,000,000. The second tax contingency, of $7,000,000 was resolved with the IRS in September 2006 and as a result, the reserve is no longer required. The reserve was applied to the goodwill acquired as part of the LFIN acquisition. The Company will continue to monitor the IRS review of the remaining tax matter.

Note 10 Capital Ratios

The Company had a leverage ratio of 7.37% and 7.26%, risk-weighted Tier 1 capital ratio of 12.60% and 12.97% and risk-weighted total capital ratio of 13.76% and 14.22% at September 30, 2006 and December 31, 2005, respectively. The identified intangibles and goodwill of $317,820,000 as of September 30, 2006, recorded in connection with the acquisitions made by the Company, are deducted from the sum of core capital elements when determining the capital ratios of the Company. The Company actively monitors the regulatory capital ratios to ensure that the Company s bank subsidiaries are well capitalized under the regulatory framework.

In March 2005, the Federal Reserve Board issued a final rule that would continue to allow the inclusion of trust preferred securities in Tier 1 capital, but with stricter quantitative limits. Under the final rule, after a five-year transition period ending March 31, 2009, the aggregate amount of trust preferred securities and certain other capital elements would be limited to 25% of Tier 1 capital elements, net of goodwill, less any associated deferred tax liability. The amount of trust preferred securities and certain other elements in excess of the limit could be included in Tier 2 capital, subject to restrictions. Bank holding companies with significant international operations will be expected to limit trust preferred securities to 15% of Tier 1 capital elements, net of goodwill; however, they may include qualifying mandatory convertible preferred securities up to the 25% limit.

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

Special Cautionary Notice Regarding Forward Looking Information

Certain matters discussed in this report, excluding historical information, include forward-looking statements, within the meaning of Section 27A of the Securities Exchange Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by these sections. Although the Company believes such forward-looking statements are based on reasonable assumptions, no assurance can be given that every objective will be reached. The words estimate, expect, intend, believe and project, as wel other words or expressions of a similar meaning are intended to identify forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this report. Such statements are based on current expectations, are inherently uncertain, are subject to risks and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors.

Factors that could cause actual results to differ materially from any results that are projected, forecasted, estimated or budgeted by the Company in forward-looking statements include, among others, the following possibilities:

- Changes in interest rates and market prices, which could reduce the Company s net interest margins, asset valuations and expense expectations.

- Changes in the capital markets utilized by the Company and its subsidiaries, including changes in the interest rate environment that may reduce margins.

- Changes in state and/or federal laws and regulations to which the Company and its subsidiaries, as well as their customers, competitors and potential competitors, are subject, including, without limitation, changes in the accounting, tax and regulatory treatment of trust preferred securities, as well as changes in banking, tax, securities, insurance and employment laws and regulations.

- Changes in U.S. Mexico trade, including, without limitation, reductions in border crossings and commerce resulting from the Homeland Security Programs called US-VISIT, which is derived from Section 110 of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996.

- The loss of senior management or operating personnel.

- Increased competition from both within and outside the banking industry.

- Changes in local, national and international economic business conditions that adversely affect the Company s customers and their ability to transact profitable business with the Company, including the ability of its borrowers to repay their loans according to their terms or a change in the value of the related collateral.

- The timing, impact and other uncertainties of the Company s potential future acquisitions including the Company s ability to identify suitable potential future acquisition candidates, the success or failure in the integration of their operations and the Company s ability to maintain its current branch network and to enter new markets successfully and capitalize on growth opportunities.

- Changes in the Company s ability to pay dividends on its Common Stock.

- The effects of the litigation and proceedings pending with the Internal Revenue Service regarding the Company s lease financing transactions.

- Additions to the Company s loan loss allowance as a result of changes in local, national or international conditions which adversely affect the Company s customers.

- Political instability.
- Technological changes.
- Acts of war or terrorism.
- Natural disasters.
- 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 standards setters.

It is not possible to foresee or identify all such factors. The Company makes no commitment to update any forward-looking statement, or to disclose any facts, events or circumstances after the date hereof that may affect the accuracy of any forward-looking statement, unless required by law.

Overview

The Company, which is headquartered in Laredo, Texas, with more than 205 facilities and more than 340 ATMs, provides banking services for commercial, consumer and international customers of South, Central and Southeast Texas and the State of Oklahoma. The Company is one of the largest independent commercial bank holding companies headquartered in Texas. The Company, through its bank subsidiaries, is in the business of gathering funds from various sources and investing those funds in order to earn a return. The Company either directly or through a bank subsidiary owns two insurance agencies, a broker/dealer and a majority interest in an investment banking unit that owns a broker/dealer. The Company s primary earnings come from the spread between the interest earned on interest-bearing assets and the interest paid on interest-bearing liabilities. In addition, the Company generates income from fees on products offered to commercial, consumer and international customers.

The Company is very active in facilitating trade along the United States border with Mexico. The Company does a large amount of business with customers domiciled in Mexico. Deposits from persons and entities domiciled in Mexico comprise a large and stable portion of the deposit base of the Company s bank subsidiaries. The Company also serves the growing Hispanic population through the Company s facilities located throughout South, Central and Southeast Texas and the State of Oklahoma.

Expense control is an essential element in the Company s long-term profitability. As a result, one of the key ratios the Company monitors is the efficiency ratio, which is a measure of non-interest expense to net-interest income plus non-interest income. Except for the nine months ended September 30, 2006, the Company s efficiency ratio has been under 55% for each of the last five years, which the Company believes is better than average compared to its national peer group considering the Company s aggressive de novo branch expansion. The Company s efficiency ratio has increased over the last few years because of the Company s aggressive branch expansion which has added 52 branches in 2005 and 2006. The efficiency ratio for the first nine months of 2006 was negatively affected by the $8.9 million, net of tax, expense recognized in connection with the tax litigation. During rapid expansion periods, the Company s efficiency ratio will suffer but the long term benefits of the expansion should be realized in future periods and the benefits should positively impact the efficiency ratio in future periods.

Results of Operations

Summary

Consolidated Statements of Condition Information

	September 30, 2006 (Dollars in Thousands)	December 31, 2005	Percent Increase (Decrease)
Assets	$ 10,690,326	$ 10,391,853	2.9 %
Net loans	4,845,894	4,547,896	6.6
Deposits	6,715,162	6,656,426	.9
Other borrowed funds	2,166,872	1,870,075	15.9
Junior subordinated deferrable interest debentures	210,801	236,391	(10.8)
Shareholders equity	824,861	792,867	4.0

Consolidated Statements of Income Information

	Three Months Ended September 30, (Dollars in Thousands) 2006	2005	Percent Increase (Decrease)	Nine Months Ended September 30, (Dollars in Thousands) 2006	2005	Percent Increase (Decrease)
Interest income	$ 156,552	$ 129,968	20.5 %	$ 448,244	$ 374,447	19.7 %
Interest expense	86,600	54,745	58.2	231,930	144,152	60.9
Net interest income	69,952	75,223	(7.0)	216,314	230,295	(6.1)
Provision for possible loan losses	1,954	(196)	(1,096.9)	2,633	2,635	(.1)
Non-interest income	40,058	40,883	(2.0)	127,697	120,613	5.9
Non-interest expense	69,028	64,620	6.8	215,605	189,633	13.7
Net income	26,593	35,468	(25.0)	85,226	106,500	(20.0)
Per common share (adjusted for stock dividends):						
Basic	$ .42	$ .56	(25.0)%	$ 1.35	$ 1.67	(19.2)%
Diluted	.42	.55	(23.6)	1.33	1.65	(19.4)

Net Income

Net income for the first nine months of 2006 was negatively impacted by a $8.9 million, net of tax, charge to operations as a result of the loss of a IRS tax lawsuit that was litigated during the third quarter of 2005 in the Federal District Court in San Antonio, Texas and that relates to certain leasing transactions previously discussed in Footnote 17 of the Notes to Consolidated Financial Statements set forth in the Company s 2005 Annual Report. Because of the trial court judgment issued on March 31, 2006, the uncertainty of the outcome at the appellate level and the similarity between the litigated lawsuit and the other tax case that is pending, the Company took the $8.9 million charge, net of tax. Net income for the first nine months of 2005 was positively impacted by a $5.6 million distribution, net of tax, from the January 2005 merger of the PULSE EFT Association with Discover Financial Services, a business unit of Morgan Stanley, received in the first and second quarter 2005. The Company, as a member of the PULSE EFT Association received the cash distributions based in part upon its volume of transactions through the PULSE network.

In the third quarter 2006, the Company incurred a securities loss of $880,000, after tax, to reposition a portion of its securities portfolio. Additionally, a loss of $836,000, after tax, was recorded to reflect the Company s share of losses on an equity investment held by its lead bank. Net income for the third quarter of 2006 and 2005 was positively affected by gains of sales of loans of $763,000 and $1.9 million, after tax, respectively. Additionally, net income has been negatively impacted by the inverted yield curve and increasing competition for deposits. The Company has also been negatively impacted by the increasing de novo branching activity by the Company in its markets resulting in 20 new branches in 2006 and 32 new branches in 2005. The Company believes that the de novo branching will help in attracting new low cost deposits and loans and also help with the retention of current customers as more out of market banks expand their branching activities in Texas; however, the Company realizes that there is a certain amount of time before each branch becomes profitable and thus negatively impacts earnings in the short term. The Company has continued to foster the growth of loans to improve net interest income; however, this process of expanding quality loan balances takes a certain amount of time and also increases the provision for loan losses in periods of expansion.

Net Interest Income

	Three Months Ended September 30, (in Thousands) 2006	2005	Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands) 2006	2005	Percent Increase (Decrease)
Interest income:						
Loans, including fees	$ 104,837	$ 86,304	21.5 %	$ 292,441	$ 250,974	16.5 %
Federal funds sold	748	1,079	(30.7)	2,942	2,433	20.9
Investment securities:						
Taxable	49,728	41,274	20.5	149,094	116,965	27.5
Tax-exempt	1,136	1,209	(6.0)	3,452	3,646	(5.3)
Other interest income	103	102	1.0	315	429	(26.6)
Total interest income	156,552	129,968	20.5	448,244	374,447	19.7
Interest expense:						
Savings deposits	9,743	7,335	32.8	28,786	18,970	51.7
Time deposits	32,759	18,959	72.8	88,379	50,041	76.6
Securities sold under repurchase agreements	7,319	7,219	1.4	22,867	19,758	15.7
Other borrowings	29,423	16,403	79.4	74,157	41,836	77.3
Junior subordinated interest deferrable debentures	7,356	4,829	52.3	17,741	13,547	31.0
Total interest expense	86,600	54,745	58.2	231,930	144,152	60.9
Net interest income	$ 69,952	$ 75,223	(7.0)%	$ 216,314	$ 230,295	(6.1)%

Net interest income is the spread between income on interest earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, such as deposits, repurchase agreements and funds borrowed. Net interest income is the Company s largest source of revenue. Net interest income is affected by both changes in the level of interest rates and changes in the amount and composition of interest earning assets and interest bearing liabilities.

As part of its strategy to manage interest rate risk, the Company strives to manage both assets and liabilities so that interest sensitivities match. One method of calculating interest rate sensitivity is through gap analysis. A gap is the difference between the amount of interest rate sensitive assets and interest rate sensitive liabilities that re-price or mature in a given time period. Positive gaps occur when interest rate sensitive assets exceed interest rate sensitive liabilities, and negative gaps occur when interest rate sensitive liabilities exceed interest rate sensitive assets. A positive gap position in a period of rising interest rates should have a positive effect on net interest income as assets will re-price faster than liabilities. Conversely, net interest income should contract somewhat in a period of falling interest rates. Management can quickly change the Company s interest rate position at any given point in time as market conditions dictate. Additionally, interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Analytical techniques employed by the Company to supplement gap analysis include simulation analysis to quantify interest rate risk exposure. The gap analysis prepared by management is reviewed by the Investment Committee of the Company twice a year (see table on page 25 for the September 30, 2006 gap analysis). Management currently believes that the Company is properly positioned for interest rate changes; however if management determines at any time that the Company is not properly positioned, it will strive to adjust the interest rate sensitive assets and liabilities in order to manage the effect of interest rate changes.

Non-Interest Income

	Three Months Ended September 30, (in Thousands) 2006	2005	Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands) 2006	2005	Percent Increase (Decrease)
Service charges on deposit accounts	$ 21,324	$ 21,857	(2.4)%	$ 63,839	$ 62,761	1.7 %
Other service charges, commissions and fees						
Banking	7,451	6,094	22.3	21,680	18,372	18.0
Non-banking	6,000	3,241	85.1	14,011	7,352	90.6
Investment securities transactions, net	(1,353)		100.0	(943)	(181)	421.0
Other investments, net	3,389	3,802	(10.9)	15,346	11,665	31.6
Other income	3,247	5,889	(44.9)	13,764	20,644	(33.3)
Total non-interest income	$ 40,058	$ 40,883	(2.0)%	$ 127,697	$ 120,613	5.9 %

The increase in non-banking service charges, commissions and fees for the three months ended and nine months ended September 30, 2006 can be attributed to additional income recognized by the Company s investment services unit. Other income for the first nine months of 2005 reflects a gain of $8,636,000 from a distribution resulting from the January 2005 merger of the PULSE EFT Association with Discover Financial Services, a business unit of Morgan Stanley, of which $7,363,000 was received in the first quarter 2005 and $1,273,000 was received in the second quarter. Members of the PULSE EFT Association received these distributions based in part upon their volume of transactions through the PULSE network.

Non-Interest Expense

	Three Months Ended September 30, (in Thousands) 2006	2005	Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands) 2006	2005	Percent Increase (Decrease)
Employee compensation and benefits	$ 31,418	$ 28,518	10.2 %	$ 91,042	$ 84,288	8.0 %
Occupancy	6,919	6,269	10.4	19,667	17,655	11.4
Depreciation of bank premises and equipment	7,201	6,657	8.2	21,006	18,464	13.8
Professional fees	2,819	2,869	(1.7)	8,289	9,088	(8.8)
Stationery and supplies	1,568	1,297	20.9	4,469	4,048	10.4
Amortization of identified intangible assets	1,217	1,298	(6.2)	3,650	3,895	(6.3)
Advertising	2,891	2,996	(3.5)	8,935	8,404	6.3
Other	14,995	14,716	1.9	58,547	43,791	33.7
Total non-interest expense	$ 69,028	$ 64,620	6.8 %	$ 215,605	$ 189,633	13.7 %

The increase in other expense for the nine months ended September 30, 2006 can be attributed to the $13,640,000 in connection with the tax lawsuits (See Note 9 to the consolidated financial statements) expensed in the first quarter 2006. Non-interest expense was also negatively affected by the aggressive de novo branching activity that has added 52 new branches in 2005 and 2006.

Financial Condition

Allowance for Possible Loan Losses

The allowance for possible loan losses decreased 16.5% to $64,933,000 at September 30, 2006 from $77,796,000 at December 31, 2005. The provision for possible loan losses charged to expense decreased .1% to $2,633,000 for the nine months ended September 30, 2006 from $2,635,000 for the same period in 2005. The decrease in the allowance for possible loan losses can be attributed to the charge off of loans acquired as part of the Local Financial Corporation (LFIN) acquisition. The decrease in the provision for possible loan losses charged to expense can be attributed to the lack of substantial growth in the loan portfolio. The allowance for possible loan losses was 1.3% of total loans, net of unearned income at September 30, 2006 and 1.7% at December 31, 2005.

Investment Securities

Investment securities increased 2.7% to $4,382,529,000 at September 30, 2006, from $4,269,327,000 at December 31, 2005.

Loans

Loans, net of unearned discounts increased 6.2% to $4,910,827,000 at September 30, 2006, from $4,625,692,000 at December 31, 2005. The increase occurred despite the decline of loans as a result of the Company s strategy to reduce the exposure to certain loan categories that LFIN employed prior to the acquisition by the Company. LFIN had a national real estate group that loaned funds throughout the United States and after extensive review by the Company, the Company concluded the national real estate group goals were not consistent with the Company s loan origination goals that emphasize risk, pricing and the desire to lend primarily in the markets that the Company occupies.

Deposits

Deposits increased .9% to $6,715,162, at September 30, 2006, from $6,656,426 at December 31, 2005. The change in deposits is primarily the result of the Company s internal sales program despite the Company strategically reducing certain deposit categories of LFIN such as brokered deposits and certain public fund deposits. The Company decided not to continue the recruitment of brokered deposits and certain public funds because of the high expense associated with those types of funding sources and the lack of relationships those deposits carry.

Foreign Operations

On September 30, 2006, the Company had $10,690,326,000 of consolidated assets, of which approximately $311,128,000, or 2.9%, was related to loans outstanding to borrowers domiciled in foreign countries, compared to $281,947,000, or 2.7%, at December 31, 2005. Of the $311,128,000, 77.2% is directly or indirectly secured by U.S. assets, certificates of deposits and real estate; 21.5% is secured by foreign real estate; .3% is secured by foreign real estate related to maquiladora plants and guaranteed under lease obligations primarily by U.S. companies, many of which are on the Fortune 500 list of companies; and 1.0% is unsecured.

Critical Accounting Policies

The Company has established various accounting policies which govern the application of accounting principles in the preparation of the Company s consolidated financial statements. The significant accounting policies are described in the footnotes to the consolidated financial statements. Certain accounting policies involve significant subjective judgments and assumptions by management which have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies.

The Company considers its Allowance for Possible Loan Losses as a policy critical to the sound operations of the bank subsidiaries. The allowance for possible loan losses consists of the aggregate loan loss allowances of the bank subsidiaries. The allowances are established through charges to operations in the form of provisions for possible loan losses. Loan losses or recoveries are charged or credited directly to the allowances. The allowance for possible loan losses of each bank subsidiary is maintained at a level considered appropriate by management, based on estimated probable losses in the loan portfolio. The allowance is derived from the following elements: (i) allowances established on specific loans and (ii) allowances based on historical loss experience on the Company s remaining loan portfolio, which includes general economic conditions and other qualitative risk factors both internal and external to the Company. See also discussion regarding the allowance for possible loan losses and provision for possible loan losses included in the results of operations and Provision and Allowance for Possible Loan Losses included in Notes 1 and 5 of the notes to Consolidated Financial Statements in the Company s latest Annual Report on Form 10K for further information regarding the Company s provision and allowance for possible loan losses policy.

Through December 31, 2005, the Company accounted for stock-based employee compensation plans based on the intrinsic value method provided in Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, (APB No. 25), and related interpretations. Because the exercise price of the Company s employee stock options equals the market price of the underlying stock on the measurement date, which is generally the date of grant, no compensation expense was recognized on options granted. Compensation expense for stock awards is based on the market price of the stock on the measurement date, which is generally the date of grant, and is recognized ratably over the service period of the award.

Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation, as amended by Statement of Financial Accounting Standards No. 148 (SFAS No. 148), Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123, requires pro forma disclosures of net income and earnings per share for companies not adopting its fair value accounting method for stock-based employee compensation. The pro forma disclosures presented in Note 3 in the accompanying Notes to Consolidated Financial Statements included elsewhere in this report use the fair value method of SFAS No. 123 to measure compensation expense for stock-based employee compensation plans. The fair value of stock options granted was estimated as the measurement date, which is generally the date of grant, using the Black-Sholes-Merton option-pricing model. This model was developed for use in estimating the fair value of publicly traded options that have no vesting restrictions and are fully transferable. Additionally, the model requires the input of highly subjective assumptions. Because the Company s employee stock options have characteristics significantly different from those of publicly traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the Black-Sholes-Merton option-pricing model does not necessarily provide a reliable single measure of the fair value of the Company s stock options.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R (SFAS No. 123R), Share-Based Payment (Revised 2004). Among other things, SFAS No. 123R eliminates the ability to account for stock-based compensation using APB No. 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the date of the grant. SFAS No. 123R was adopted by the Company on January 1, 2006.

Liquidity and Capital Resources

The maintenance of adequate liquidity provides the Company s bank subsidiaries with the ability to meet potential depositor withdrawals, provide for customer credit needs, maintain adequate statutory reserve levels and take full advantage of high-yield investment opportunities as they arise. Liquidity is afforded by access to financial markets and by holding appropriate amounts of liquid assets. The Company s bank subsidiaries derive their liquidity largely from deposits of individuals and business entities. Deposits from persons and entities domiciled in Mexico comprise a stable portion of the deposit base of the Company s bank subsidiaries. Other important funding sources for the Company s bank subsidiaries during 2006 and 2005 have been borrowings from FHLB, securities sold under repurchase agreements and large certificates of deposit, requiring management to closely monitor its asset/liability mix in terms of both rate sensitivity and maturity distribution. Primary liquidity of the Company and its subsidiaries has been maintained by means of increased investment in shorter-term securities, certificates of deposit and repurchase agreements. As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities and respond accordingly to anticipated fluctuations in interest rates over reasonable periods of time.

The Company maintains an adequate level of capital as a margin of safety for its depositors and shareholders. At September 30, 2006, shareholders equity was $824,861,000 compared to $792,867,000 at December 31, 2005, an increase of $31,994,000, or 4.0%. The increase in shareholders equity can be attributed to the retention of earnings despite the increase in the amount of treasury stock recorded throughout the quarter, and the cash dividend paid to shareholders on May 1, 2006.

The Company had a leverage ratio of 7.37% and 7.26%, risk-weighted Tier 1 capital ratio of 12.60% and 12.97% and risk-weighted total capital ratio of 13.76% and 14.22% at September 30, 2006 and December 31, 2005, respectively. The identified intangibles and goodwill of $317,820,000 as of September 30, 2006, recorded in connection with the Company s acquisitions, are deducted from the sum of core capital elements when determining the capital ratios of the Company.

As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities, and respond accordingly to anticipate fluctuations in interest rates by adjusting the balance between sources and uses of funds as deemed appropriate. The net-interest rate sensitivity as of September 30, 2006 is illustrated in the table on the following page. This information reflects the balances of assets and liabilities for which rates are subject to change. A mix of assets and liabilities that are roughly equal in volume and re-pricing characteristics represents a matched interest rate sensitivity position. Any excess of assets or liabilities results in an interest rate sensitivity gap.

The Company undertakes an interest rate sensitivity analysis to monitor the potential risk on future earnings resulting from the impact of possible future changes in interest rates on currently existing net asset or net liability positions. However, this type of analysis is as of a point-in-time position, when in fact that position can quickly change as market conditions, customer needs, and management strategies change. Thus, interest rate changes do not affect all categories of asset and liabilities equally or at the same time. As indicated in the table, the Company is liability sensitive during the early time periods and asset sensitive in the longer periods. The Company s Asset and Liability Committee semi-annually reviews the consolidated position along with simulation and duration models, and makes adjustments as needed to control the Company s interest rate risk position. The Company uses modeling of future events as a primary tool for monitoring interest rate risk.

Interest Rate Sensitivity

(Dollars in Thousands)

September 30, 2006	Rate/Maturity 3 Months or Less	Over 3 Months to 1 Year	Over 1 Year to 5 Years	Over 5 Years	Total
Rate sensitive assets					
Federal funds sold	$ 42,000	$	$	$	$ 42,000
Time deposits with banks	396				396
Investment securities	26,922	1,585,561	1,199,066	1,570,980	4,382,529
Loans, net of non-accruals	3,530,800	317,346	465,701	580,795	4,894,642
Total earning assets	$ 3,600,118				