

INTERNATIONAL BANCSHARES CORP  
Form 10-Q  
November 07, 2008

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2008**

**OR**

**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)

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**Texas**  
(State or other jurisdiction of  
incorporation or organization)

**74-2157138**  
(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  No

Indicate by check mark if the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

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	68,579,446 shares outstanding at November 3, 2008



## PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Condition (Unaudited)

(Dollars in Thousands)

	September 30, 2008	December 31, 2007
<b>Assets</b>		
Cash and due from banks	\$ 287,087	\$ 329,052
Federal funds sold	60,000	17,000
Total cash and cash equivalents	347,087	346,052
Time deposits with banks	396	4,852
Investment securities:		
Held-to-maturity (Market value of \$2,300 on September 30, 2008 and \$2,300 on December 31, 2007)	2,300	2,300
Available-for-sale (Amortized cost of \$4,315,996 on September 30, 2008 and \$4,167,624 on December 31, 2007)	4,322,219	4,167,888
Total investment securities	4,324,519	4,170,188
Loans, net of unearned discounts	5,740,914	5,536,628
Less allowance for possible loan losses	(68,963)	(61,726)
Net loans	5,671,951	5,474,902
Bank premises and equipment, net	455,194	435,654
Accrued interest receivable	46,444	54,301
Other investments	341,620	323,565
Identified intangible assets, net	27,610	31,507
Goodwill, net	282,532	283,198
Other assets	47,243	42,942
Total assets	\$ 11,544,596	\$ 11,167,161

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Condition, continued (Unaudited)

(Dollars in Thousands)

	September 30, 2008	December 31, 2007
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities:</b>		
<b>Deposits:</b>		
Demand non-interest bearing	\$ 1,460,564	\$ 1,512,627
Savings and interest bearing demand	2,227,956	2,292,589
Time	3,312,836	3,352,390
<b>Total deposits</b>	<b>7,001,356</b>	<b>7,157,606</b>
Securities sold under repurchase agreements	1,468,006	1,328,983
Other borrowed funds	1,624,750	1,456,936
Junior subordinated deferrable interest debentures	201,039	200,929
Other liabilities	254,372	86,802
<b>Total liabilities</b>	<b>10,549,523</b>	<b>10,231,256</b>
<b>Commitments, Contingent Liabilities and Other Tax Matters (Note 10)</b>		
<b>Shareholders equity:</b>		
Common shares of \$1.00 par value. Authorized 275,000,000 shares; issued 95,472,886 shares on September 30, 2008 and 95,440,983 shares on December 31, 2007	95,473	95,441
Surplus	145,218	144,140
Retained earnings	984,301	929,145
Accumulated other comprehensive income	4,025	165
	1,229,017	1,168,891
Less cost of shares in treasury, 26,892,726 shares on September 30, 2008 and 26,848,880 shares on December 31, 2007	(233,944)	(232,986)
<b>Total shareholders equity</b>	<b>995,073</b>	<b>935,905</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 11,544,596</b>	<b>\$ 11,167,161</b>

See accompanying notes to consolidated financial statements.



## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Income (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
<b>Interest income:</b>				
Loans, including fees	\$ 91,020	\$ 112,214	\$ 281,569	\$ 334,193
Federal funds sold	226	700	907	2,217
<b>Investment securities:</b>				
Taxable	45,996	44,862	138,246	142,300
Tax-exempt	846	1,046	2,680	3,255
Other interest income	106	336	383	2,456
<b>Total interest income</b>	<b>138,194</b>	<b>159,158</b>	<b>423,785</b>	<b>484,421</b>
<b>Interest expense:</b>				
Savings deposits	6,807	14,233	22,609	41,024
Time deposits	24,093	36,297	85,360	107,570
Securities sold under repurchase agreements	12,486	11,718	38,612	30,253
Other borrowings	7,133	14,821	24,546	60,203
Junior subordinated interest deferrable debentures	3,461	4,281	10,586	13,226
Other interest expense	96		184	
<b>Total interest expense</b>	<b>54,076</b>	<b>81,350</b>	<b>181,897</b>	<b>252,276</b>
<b>Net interest income</b>	<b>84,118</b>	<b>77,808</b>	<b>241,888</b>	<b>232,145</b>
Provision for possible loan losses	7,037	(3,916)	12,690	(1,357)
<b>Net interest income after provision for possible loan losses</b>	<b>77,081</b>	<b>81,724</b>	<b>229,198</b>	<b>233,502</b>
<b>Non-interest income:</b>				
Service charges on deposit accounts	25,354	23,318	74,596	64,602
<b>Other service charges, commissions and fees</b>				
Banking	10,437	8,800	30,599	25,761
Non-banking	2,267	5,061	5,412	13,892
Gain (loss) on investment securities transactions, net		(1,031)	6,410	(15,941)
Other investments, net	5,785	4,226	13,895	14,794
Other income	6,980	5,243	17,222	16,017
<b>Total non-interest income</b>	<b>50,823</b>	<b>45,617</b>	<b>148,134</b>	<b>119,125</b>

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Income, continued (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Non-interest expense:				
Employee compensation and benefits	\$ 32,854	\$ 34,645	\$ 95,314	\$ 97,800
Occupancy	9,955	8,172	27,053	23,515
Depreciation of bank premises and equipment	9,481	8,178	27,119	23,547
Professional fees	2,557	3,014	8,442	8,483
Stationery and supplies	1,540	1,466	4,134	4,437
Amortization of identified intangible assets	1,299	1,332	3,897	3,861
Advertising	3,667	3,391	10,329	9,811
Other	15,238	18,154	47,682	52,397
Total non-interest expense	76,591	78,352	223,970	223,851
Income before income taxes	51,313	48,989	153,362	128,776
Provision for income taxes	17,433	16,327	52,953	42,880
Net income	\$ 33,880	\$ 32,662	\$ 100,409	\$ 85,896
Basic earnings per common share:				
Weighted average number of shares outstanding:	68,571,661	68,898,059	68,573,318	69,174,016
Net income	\$ .49	\$ .47	\$ 1.46	\$ 1.24
Fully diluted earnings per common share:				
Weighted average number of shares outstanding:	68,727,949	69,090,549	68,715,082	69,575,373
Net income	\$ .49	\$ .47	\$ 1.46	\$ 1.23

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,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	\$ 33,880	\$ 32,662	\$ 100,409	\$ 85,896
Other comprehensive income, net of tax				
Net unrealized holding (losses) gains on securities available for sale arising during period	(6,074)	13,471	(2,550)	41,992
Reclassification adjustment for (losses) gains on securities available for sale included in net income		(1,031)	6,410	(15,941)
Comprehensive income	\$ 27,806	\$ 45,102	\$ 104,269	\$ 111,947

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,	
	2008	2007
Operating activities:		
Net income	\$ 100,409	\$ 85,896
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision (credit) for possible loan losses	12,690	(1,357)
Amortization of loan premiums	134	239
Accretion of time deposits with banks	1	(49)
Accretion of time deposit discounts	(28)	(9)
Depreciation of bank premises and equipment	27,119	23,547
Gain on sale of bank premises and equipment	(44)	(3,409)
Depreciation and amortization of leased assets	760	1,625
Accretion of investment securities discounts	(858)	(439)
Amortization of investment securities premiums	4,787	3,173
Investment securities transactions, net	(6,410)	15,941
Amortization of junior subordinated debenture discounts	110	292
Amortization of identified intangible assets	3,897	3,861
Stock based compensation expense	550	581
Earnings from affiliates and other investments	(9,773)	(7,852)
Deferred tax benefit	(7,727)	(2,261)
Decrease in accrued interest receivable	7,857	2,770
Net decrease in other assets	(4,226)	(5,015)
Net increase in other liabilities	150,397	14,087
Net cash provided by operating activities	279,645	131,621
Investing activities:		
Proceeds from maturities of securities	16,261	21,903
Proceeds from sales of available for sale securities	8,359	841,081
Purchases of available for sale securities	(1,152,190)	(1,103,277)
Principal collected on mortgage-backed securities	981,679	738,989
Maturities of time deposits with banks	4,457	35,643
Net increase in loans	(209,873)	(168,233)
Purchases of other investments	(8,315)	(54,922)
Distributions of other investments	33	97,262
Purchases of bank premises and equipment	(47,415)	(56,513)
Proceeds from sale of bank premises and equipment	800	7,917
Adjustment to goodwill related to prior acquisition		5,885
Cash paid in purchase transaction		(23,470)
Cash acquired in purchase transaction		30,772

Net cash (used in) provided by investing activities	(406,204)	373,037
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## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Cash Flows, continued (Unaudited)

(Dollars in Thousands)

	Nine Months Ended September 30,	
	2008	2007
Financing activities:		
Net decrease in non-interest bearing demand deposits	\$ (52,063)	\$ (62,287)
Net (decrease) increase in savings and interest bearing demand deposits	(64,633)	55,041
Net decrease in time deposits	(39,526)	(79,068)
Net increase in securities sold under repurchase agreements	139,023	534,925
Net increase (decrease) in other borrowed funds	167,814	(954,490)
Proceeds of issuance of long-term debt		53,609
Principal payments of long term-debt		(53,610)
Purchase of treasury stock	(958)	(28,393)
Proceeds from stock transactions	560	5,640
Payment of cash dividends	(22,623)	(22,086)
Payment of cash dividends in lieu of fractional shares		(27)
Net cash provided by (used in) financing activities	127,594	(550,746)
Increase (decrease) in cash and cash equivalents	1,035	(46,088)
Cash and cash equivalents at beginning of period	346,052	297,207
Cash and cash equivalents at end of period	\$ 347,087	\$ 251,119
Supplemental cash flow information:		
Interest paid	\$ 191,610	\$ 250,212
Income taxes paid	51,711	51,508
Dividends declared, not yet paid	22,630	
Adjustment to goodwill arising from prior acquisition		2,076

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. 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, 2007 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 Statement of Financial Accounting Standards No. 131 ( 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.

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157 ( SFAS No. 157 ), Fair Value Measurements for financial assets and financial liabilities. In accordance with Financial Accounting Standards Board Staff Position No. 157-2, ( FSP No. 157-2 ), Effective date of FASB Statement No. 157, the Company will delay application of SFAS No. 157 for non-financial assets and non-financial liabilities until January 1, 2009, except for those that are recognized or disclosed at fair value on a recurring basis. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies to all financial instruments that are being measured and reported on a fair value basis. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into the following three levels:

- Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities.

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- **Level 2 Inputs** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- **Level 3 Inputs** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or other valuation techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below.

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The following table represents assets and liabilities reported on the consolidated balance sheets at their fair value as of September 30, 2008 by level within the SFAS No. 157 fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date Using (Dollars in Thousands)			
	Assets/Liabilities Measured at Fair Value September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Investment securities available-for-sale	\$ 4,322,219	\$ 727	\$ 4,321,492	\$
<i>Measured on a non-recurring basis:</i>				
Assets:				
Impaired Loans	78,543		78,543	

Investment securities available-for-sale are classified within Level 2 of the valuation hierarchy, with the exception of certain equity investments that are classified within Level 1. The Company obtains fair value measurements for investment securities from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Impaired loans are classified within Level 2 of the valuation hierarchy. The fair value of impaired loans is derived in accordance with Statement of Financial Accounting Standards No. 114 ( SFAS No. 114 ), Accounting by Creditors for Impairment of a Loan. The fair value of impaired loans is based on the fair value of the collateral, as determined through an external appraisal process. Impaired loans are primarily comprised of collateral-dependent commercial loans.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis. The instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).

### Note 2 Acquisition

On March 16, 2007, the Company completed its acquisition of Southwest First Community, Inc. ( Southwest Community ), a bank holding company with approximately \$133 million in assets that owned State Bank & Trust in Beeville, Texas and Commercial State Bank in Sinton, Texas. The transaction was pursuant to the Agreement and Plan of Merger dated December 1, 2006 (the Merger Agreement ). The Company paid consideration totaling \$23.5 million in cash.

**Note 3 Loans**

A summary of net loans, by loan type at September 30, 2008 and December 31, 2007 is as follows:

	September 30, 2008	December 31, 2007
	(Dollars in Thousands)	
Commercial, financial and agricultural	\$ 2,521,270	\$ 2,426,064
Real estate mortgage	867,097	798,708
Real estate construction	1,896,091	1,835,950
Consumer	172,055	190,899
Foreign	284,401	285,008
<b>Total loans</b>	<b>5,740,914</b>	<b>5,536,629</b>
Unearned discount		(1)
<b>Loans, net of unearned discount</b>	<b>\$ 5,740,914</b>	<b>\$ 5,536,628</b>

**Note 4 - Allowance for Possible Loan Losses**

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

	September 30, 2008	September 30, 2007
	(Dollars in Thousands)	
Balance at December 31,	\$ 61,726	\$ 64,537
Losses charged to allowance	(6,345)	(5,297)
Recoveries credited to allowance	892	4,138
Net losses charged to allowance	(5,453)	(1,159)
Provision charged to operations	12,690	(1,357)
Allowance acquired in acquisition (Note 2)		1,054
<b>Balance at September 30,</b>	<b>\$ 68,963</b>	<b>\$ 63,075</b>

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, 2008	December 31, 2007
	(Dollars in Thousands)	
Balance of impaired loans where there is a related allowance for loan loss	\$ 40,243	\$ 39,618
Balance of impaired loans where there is no related allowance for loan loss	47,443	
Total impaired loans	\$ 87,686	\$ 39,618
Allowance allocated to impaired loans	\$ 9,143	\$ 4,903

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 \$62,324,000 and \$22,590,000 for the nine months and year ended September 30, 2008 and December 31, 2007, respectively. The interest recognized on impaired loans was not significant. The increase in the balance of impaired loans can be partially attributed to a certain energy related loan that filed for bankruptcy protection and certain other loans that deteriorated during the last nine months; however, a substantial amount of the impaired loans have adequate collateral and credit enhancements to justify not allocating a related allowance for loan loss.

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, 2008 was adequate to absorb probable losses from loans in the portfolio at that date.

#### Note 5 Stock Options

On April 1, 2005, the Board of Directors adopted the 2005 International Bancshares Corporation Stock Option Plan (the 2005 Plan). Effective May 19, 2008, the 2005 Plan was amended to increase the number of shares available for stock option grants under the 2005 Plan by 300,000 shares. 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, 2008, 370,572 shares were available for future grants under the 2005 Plan.



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A summary of option activity under the stock option plans for the nine months ended September 30, 2008 is as follows:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value (\$)
Options outstanding at December 31, 2007	924,483	\$ 21.00		
Plus: Options granted	1,500	24.61		
Less:				
Options exercised	31,903	13.76		
Options expired				
Options forfeited	36,405	23.68		
Options outstanding at September 30, 2008	857,675	\$ 21.17	3.80	\$ 5,063,900
Options fully vested and exercisable at September 30, 2008	431,180	\$ 16.48	2.01	\$ 4,589,200

Stock-based compensation expense included in the consolidated statements of income for the three and nine months ended September 30, 2008, was approximately \$174,000 and \$550,000, respectively. As of September 30, 2008, there was approximately \$1,225,900, 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 1.5 years.

### Note 6 - Investment Securities

The Company classifies debt and equity securities into one of three categories: held-to maturity, available-for-sale, or trading. Such securities 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, or in the case of losses, when deemed other than temporary.

In the first quarter 2007, the Company wrote down approximately \$732.0 million of investment securities to fair value, which resulted in an impairment charge of approximately \$17.0 million. The write down was a result of the Company's strategic identification of certain investment securities that were sold in the second quarter of 2007 with the proceeds used to reduce Federal Home Loan Bank (FHLB) borrowings. The investments sold were certain hybrid mortgage backed securities with a coupon re-set date that exceeded 30 months and a weighted average yield to coupon re-set that was approximately 100 basis points less than the FHLB certificate of indebtedness short term-rate. The sale of the securities facilitated a repositioning of the balance sheet to a more neutral position in terms of interest rate risk and improved the Company's operating ratios.

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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, 2008	December 31, 2007
	(Dollars in Thousands)	
U.S. Treasury securities		
Available-for-sale	\$ 1,326	\$ 1,308
Mortgage-backed securities		
Available-for-sale	4,236,989	4,066,828
States and political subdivisions		
Available-for-sale	69,677	84,633
Other		
Held-to-maturity	2,300	2,300
Available-for-sale	14,227	15,119
<b>Total investment securities</b>	<b>\$ 4,324,519</b>	<b>\$ 4,170,188</b>

Included in mortgage-backed securities in the table above are \$2,379,222 of mortgage-backed securities issued by either the Federal Home Loan Mortgage Corporation ( Freddie Mac ) or the Federal National Mortgage Corporation ( Fannie Mae ), \$1,775,103 of mortgage-backed securities issued by the Government National Mortgage Corporation ( Ginnie Mae ) and \$82,664 issued by non-government entities. Investments in mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. Investments in mortgage-backed securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. Government, but carry an implied AAA rating with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008. Investments in mortgage-backed securities issued by non-governmental entities are investment grade.

### Note 7 Other Borrowed Funds

Other borrowed funds include Federal Home Loan Bank borrowings, which are short-term, variable-rate 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, 2008, other borrowed funds totaled \$1,624,750,000, an increase of 11.5% from \$1,456,936,000 at December 31, 2007.

### Note 8 Junior Subordinated Interest Deferrable Debentures

The Company has formed twelve statutory business trusts under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. As part of the Local Financial Corporation ( LFIN ) acquisition, the Company acquired three additional statutory business trusts previously formed by LFIN for the purpose of issuing trust preferred securities. The twelve 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. As of September 30, 2008, the Debentures issued by four of the trusts formed by the Company and the Debentures issued by all three of the trusts formed by LFIN have been redeemed by the Company. As of September 30, 2008, the principal amount of debentures outstanding totaled \$201,039,000.

The Debentures are subordinated and junior in right of payment to all present and future senior indebtedness (as defined in the respective indentures) of the Company, and are *pari passu* with one another. The interest rate payable on, and the payment terms of the Debentures are the same as the distribution rate and payment terms of the respective issues of Capital and Common Securities issued by the Trusts. The Company has fully and unconditionally guaranteed the obligations of each of the Trusts with respect to the Capital and Common Securities. The Company has the right, unless an Event of Default (as defined in the Indentures) has occurred and is continuing, to defer payment of interest on the Debentures for up to ten consecutive semi-annual periods on Trust I and for up to twenty consecutive quarterly periods on Trusts VI, VII, VIII, IX, X, XI and XII. If interest

payments on any of the Debentures are deferred, distributions on both the Capital and Common Securities related to that Debenture would also be deferred. The redemption prior to maturity of any of the Debentures may require the prior approval of the Federal Reserve and/or other regulatory bodies.

For financial reporting purposes, the Trusts are treated as investments of the Company and not consolidated in the consolidated financial statements. Although the Capital Securities issued by each of the Trusts are not included as a component of shareholders' equity on the consolidated statement of condition, the Capital Securities are treated as capital for regulatory purposes. Specifically, under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold would qualify as Tier 2 capital. As of September 30, 2008, the total \$201,039,000 of the Capital Securities outstanding qualified as Tier 1 capital.

In March 2005, the Federal Reserve Board issued a final rule that allowed the inclusion of trust preferred securities in Tier 1 capital, but placed 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, 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. 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, 2008:

	<b>Junior Subordinated Deferrable Interest Debentures (in thousands)</b>	<b>Repricing Frequency</b>	<b>Interest Rate</b>	<b>Interest Rate Index</b>	<b>Maturity Date</b>	<b>Optional Redemption Date</b>
Trust I	\$ 10,313	Fixed	10.18%	Fixed	June 2031	June 2011
Trust VI	\$ 25,774	Quarterly	6.25%	LIBOR + 3.45	November 2032	November 2008
Trust VII	\$ 10,310	Quarterly	6.05%	LIBOR + 3.25	April 2033	October 2008
Trust VIII	\$ 25,774	Quarterly	5.84%	LIBOR + 3.05	October 2033	October 2008
Trust IX	\$ 41,238	Fixed	7.10%	Fixed	October 2036	October 2011
Trust X	\$ 34,021	Fixed	6.66%	Fixed	February 2037	February 2012
Trust XI	\$ 32,990	Fixed	6.82%	Fixed	July 2037	July 2012
Trust XII	\$ 20,619	Fixed	6.85%	Fixed	September 2037	September 2012
	\$ 201,039					

(1) Trust IX, X, XI and XII accrue interest at a fixed rate for the first five years, then floating at LIBOR + 1.62%, 1.65%, 1.62% and 1.45% thereafter, respectively.

**Note 9 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 21, 2007 and was paid on June 8, 2007. Cash dividends of \$.33 were paid on April 18, 2008 and October 15, 2008, to all holders of record on March 31, 2008 and September 30, 2008, respectively.

The Company expanded its formal stock repurchase program on May 3, 2007. Under the expanded stock repurchase program, the Company is authorized to repurchase up to \$225,000,000 of its common stock through December 2008. 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 November 3, 2008, a total of 6,200,226 shares had been repurchased under this program at a cost of \$213,005,000. 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 \$245,973,000. 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 \$245,973,000 cap will occur in the future. As of November 3, 2008, the Company has approximately \$233,978,000 invested in treasury shares, which amount has been accumulated since the inception of the Company.

**Note 10 - Commitments and Contingent Liabilities and Other Tax Matters**

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 issued a 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 FPAA's.

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 FPAA's 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. The case was tried over nine days beginning August 29, 2005. On March 31, 2006, the trial court rendered a judgment against the Company on the first FPAA. IBC timely filed its notice of appeal to the Fifth Circuit Court of Appeals. The appeal was argued on August 8, 2007 and the Trial Court decision was affirmed on August 23, 2007. The judgment became non-appealable on November 21, 2007. The other partnership case was stayed by the same Trial Court pending the appeal. Following the resolution of the first case, the trial court reopened the second case and set it for trial on September 2, 2008. Subsequently, the Company engaged in settlement negotiations with the Department of Justice, and agreed to settle the second case. Under the terms of the settlement, the Company has conceded the entire amount in dispute based upon the similarity of the facts of the second case to the first case and the likelihood of an unfavorable outcome if litigated based upon the Court rulings in the first case. On August 13, 2008, the Company filed a lawsuit in the Texas State District Court in Laredo, Texas against KPMG, LLP and a number of other third parties asserting claims against the defendants related to the underlying transactions of the two partnership tax cases.

The Company, through December 31, 2005, had previously expensed approximately \$12.0 million in connection with the lawsuits. Because of the above-referenced trial court judgment against the Company on the first FPAA and the similarity between the two FPAA's, the Company additionally expensed an approximate \$13.7 million in the first quarter of 2006. The resultant approximately \$25.7 million expensed is the total of the tax adjustments due and the interest due on such adjustments for both FPAA's. Management will continue to evaluate the correspondence with the IRS on the FPAA's and make any appropriate revisions to the amounts as deemed necessary.

**Note 11 Capital Ratios**

The Company had a leverage ratio of 8.22% and 7.76%, risk-weighted Tier 1 capital ratio of 12.20% and 11.98% and risk-weighted total capital ratio of 13.20% and 12.99% at September 30, 2008 and December 31, 2007, respectively. The identified intangibles and goodwill of \$310,142,000 as of September 30, 2008, 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, 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. 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.

**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 well as 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.

Risk 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:

- Local, regional, national and international economic business conditions and the impact they may have on the Company and 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.
- Volatility and disruption in national and international financial markets.
- Government intervention in the U.S. financial system.
- Changes in consumer spending, borrowings and savings habits.
- 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.
- 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 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.
- Greater than expected costs or difficulties related to the development and integration of new products and lines of business.
- Changes in the soundness of other financial institutions with which the Company interacts.
- Political instability in the United States and Mexico.
- Technological changes.
- Acts of war or terrorism.
- Natural disasters.
- Reduced earnings resulting from the write down of the carrying value of securities held in our securities available-for-sale portfolio following a determination that the securities are other-than-temporarily impaired.
- 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.

- The Company'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. 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 263 facilities and 420 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 fifty percent 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 with the Company's extensive branch and ATM network 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. The first nine months of 2007 was negatively affected by an impairment charge of \$13.1 million, after tax, arising from a charge on certain investment securities. This impairment charge negatively affected the efficiency ratio but does not necessarily reflect a long-term negative trend. Additionally, the Company's efficiency ratio has been negatively impacted over the last few years because of the Company's aggressive branch expansion which has added 55 branches in 2007 and the first nine months of 2008. 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. The Company monitors this ratio over time to assess the Company's efficiency relative to its peers taking into account the Company's branch expansion. The Company uses this measure as one factor in determining if the Company is accomplishing its long-term goals of providing superior returns to the Company's shareholders.

**Results of Operations**



**Summary**

## Consolidated Statements of Condition Information

	September 30, 2008 (Dollars in Thousands)		December 31, 2007		Percent Increase (Decrease)
Assets	\$	11,544,596	\$	11,167,161	3.4%
Net loans		5,671,951		5,474,902	3.6
Deposits		7,001,356		7,157,606	(2.2)
Other borrowed funds		1,624,750		1,456,936	11.5
Junior subordinated deferrable interest debentures		201,039		200,929	.1
Shareholders' equity		995,073		935,905	6.3

## Consolidated Statements of Income Information

	Three Months Ended September 30, (Dollars in Thousands)			Percent Increase (Decrease)	Nine Months Ended September 30, (Dollars in Thousands)			Percent Increase (Decrease)		
	2008		2007		2008		2007			
Interest income	\$	138,194	\$	159,158	(13.2)%	\$	423,785	\$	484,421	(12.5)%
Interest expense		54,076		81,350	(33.5)		181,897		252,276	(27.9)
Net interest income		84,118		77,808	8.1		241,888		232,145	4.2
Provision for possible loan losses		7,037		(3,916)	279.7		12,690		(1,357)	1,035.2
Non-interest income		50,823		45,617	11.4		148,134		119,125	24.4
Non-interest expense		76,591		78,352	(2.2)		223,970		223,851	(.1)
Net income		33,880		32,662	3.7		100,409		85,896	16.9
Per common share (adjusted for stock dividends):										
Basic	\$	.49	\$	.47	4.3%	\$	1.46	\$	1.24	17.7%
Diluted		.49		.47	4.3		1.46		1.23	18.7

**Net Income**

Net income for the nine months ended September 30, 2008 increased by 16.9% as compared to the same period in 2007. Net income for the first nine months of 2008 was negatively impacted by increases in the provision for possible loan losses charged to expense because of the economic turmoil currently being experienced in the United States. Net income for the first nine months of 2007 was negatively impacted by an impairment charge of \$13.1 million, after tax, on certain investments. A significant portion of the impairment charge is a result of the Company's strategic identification in 2007 of certain investment securities that were sold with the proceeds from the sales to be used to reduce Federal Home Loan Bank (FHLB) borrowings.



**Net Interest Income**

	Three Months Ended September 30, (in Thousands)			Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands)			Percent Increase (Decrease)
	2008	2007			2008	2007		
<b>Interest income:</b>								
Loans, including fees	\$ 91,020	\$ 112,214	(18.9)%	\$ 281,569	\$ 334,193	(15.7)%		
Federal funds sold	226	700	(67.7)	907	2,217	(59.1)		
<b>Investment securities:</b>								
Taxable	45,996	44,862	2.5	138,246	142,300	(2.8)		
Tax-exempt	846	1,046	(19.1)	2,680	3,255	(17.7)		
Other interest income	106	336	(68.5)	383	2,456	(84.4)		
<b>Total interest income</b>	<b>138,194</b>	<b>159,158</b>	<b>(13.2)</b>	<b>423,785</b>	<b>484,421</b>	<b>(12.5)</b>		
<b>Interest expense:</b>								
Savings deposits	6,807	14,233	(52.2)	22,609	41,024	(44.9)		
Time deposits	24,093	36,297	(33.6)	85,360	107,570	(20.6)		
Securities sold under repurchase agreements	12,486	11,718	6.6	38,612	30,253	27.6		
Other borrowings	7,133	14,821	(51.9)	24,546	60,203	(59.2)		
Junior subordinated interest deferrable debentures	3,461	4,281	(19.2)	10,586	13,226	(20.0)		
Other interest expense	96		(100.0)	184		(100.0)		
<b>Total interest expense</b>	<b>54,076</b>	<b>81,350</b>	<b>(33.5)</b>	<b>181,897</b>	<b>252,276</b>	<b>(27.9)</b>		
<b>Net interest income</b>	<b>\$ 84,118</b>	<b>\$ 77,808</b>	<b>8.1%</b>	<b>\$ 241,888</b>	<b>\$ 232,145</b>	<b>4.2%</b>		

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. The Federal Reserve Board influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. The Company's loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate, which is the rate that loan rates are indexed from, ended 2006 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%. During the first nine months of 2008, the prime interest rate decreased by 225 basis points to end the quarter at 5.00%. On October 8 and October 30, 2008, the prime interest rate decreased an additional 50 basis points on each day to end at 4.0% on October 31, 2008. The Company's goal is to manage the net interest income in periods of rising and falling rates. Net interest income increased 4.2% for the first nine months of 2008 as compared to the same period in 2007 despite the decreases in the prime interest rate.

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, 2008 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)			Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands)			Percent Increase (Decrease)
	2008	2007			2008	2007		
Service charges on deposit accounts	\$ 25,354	\$ 23,318		8.7%	\$ 74,596	\$ 64,602		15.5%
Other service charges, commissions and fees								
Banking	10,437	8,800		18.6	30,599	25,761		18.8
Non-banking	2,267	5,061		(55.2)	5,412	13,892		(61.0)
Investment securities transactions, net		(1,031)		(100.0)	6,410	(15,941)		(140.2)
Other investments, net	5,785	4,226		36.9	13,895	14,794		(6.1)
Other income	6,980	5,243		33.1	17,222	16,017		7.5
Total non-interest income	\$ 50,823	\$ 45,617		11.4%	\$ 148,134	\$ 119,125		24.4%

The increase in investment securities transactions for the nine months ended September 30, 2008 can be attributed to a \$17.0 million impairment charge recorded in connection with certain investment securities identified for sale in the first quarter 2007 and the sale of certain equity investments. The impairment charge in 2007 was the result of the Company's strategic identification of certain investment securities that were identified for sale with the proceeds from the sales used to reduce Federal Home Loan Bank (FHLB) borrowings. The investments identified were certain hybrid mortgage backed securities with a coupon re-set date that exceeded 30 months and a weighted average yield to coupon re-set that was approximately 100 basis points less than the FHLB certificate of indebtedness short-term rate. The sale of the securities facilitated a re-positioning of the balance sheet to a more neutral position in terms of interest rate risk and was done to improve the Company's operating ratios. As a result of this decision, the Company marked the securities to market. The sale of certain equity securities resulted in a gain of \$6.2 million, before taxes for the nine months ended September 30, 2008. The increase in banking service charges, commissions and fees for the first nine months of 2008 can be attributed to increased surcharge and interchange income from customers using the IBC debit card and automated teller machines (ATM).

**Non-Interest Expense**

	Three Months Ended September 30, (in Thousands)			Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands)			Percent Increase (Decrease)		
	2008		2007		2008		2007			
Employee compensation and benefits	\$	32,854	\$	34,645	(5.2)%	\$	95,314	\$	97,800	(2.5)%
Occupancy		9,955		8,172	21.8		27,053		23,515	15.0
Depreciation of bank premises and equipment		9,481		8,178	15.9		27,119		23,547	15.2
Professional fees		2,557		3,014	(15.2)		8,442		8,483	(.5)
Stationery and supplies		1,540		1,466	5.0		4,134		4,437	(6.8)
Amortization of identified intangible assets		1,299		1,332	(2.5)		3,897		3,861	.9
Advertising		3,667		3,391	8.1		10,329		9,811	5.3
Other		15,238		18,154	(16.1)		47,682		52,397	(9.0)
<b>Total non-interest expense</b>		<b>76,591</b>	<b>\$</b>	<b>78,352</b>	<b>(2.2)%</b>		<b>223,970</b>	<b>\$</b>	<b>223,851</b>	<b>(.1)%</b>

Non-interest expense was affected by the aggressive de novo branching activity that has added 17 new branches in 2008 and 38 branches in 2007, including two acquired in the Southwest First Community acquisition.

**Financial Condition****Allowance for Possible Loan Losses**

The allowance for possible loan losses increased 11.7% to \$68,963,000 at September 30, 2008 from \$61,726,000 at December 31, 2007. The provision for possible loan losses charged to expense increased 1,035.2% to \$12,690,000 for the nine months ended September 30, 2008 from \$(1,357,000) for the same period in 2007. The Company's provision for possible loan losses increased for the nine months ended September 30, 2008 because of the economic turmoil currently being experienced in the United States. As a result of this turmoil, the Company has continued to re-evaluate certain areas of its allowance for possible loan losses to reflect the appropriate amount needed as an allowance. The allowance for possible loan losses was 1.2% of total loans, net of unearned income at September 30, 2008 and 1.1% at December 31, 2007, respectively. The Company is not involved in sub-prime mortgage lending and the allowance for possible loan losses does not reflect any reserve for such lending.

**Investment Securities**

Investment securities increased 3.7% to \$4,324,519,000 at September 30, 2008, from \$4,170,188,000 at December 31, 2007. All of the mortgage-backed securities held by the Company are either fully guaranteed by the U.S. Government or issued by an agency of the Federal Government or non-governmental entities. The securities issued by Fannie Mae and Freddie Mac have an implied rating of AAA because on September 7, 2008, the two agencies were placed in conservatorship by the Federal Housing Finance Agency ( FHFA ) and, under the conservatorship of the FHFA, the federal government has provided Fannie Mae and Freddie Mac with substantial backing in the form of secured lending facilities and preferred equity capital. The actual or perceived credit quality of these agency securities may be negatively impacted by

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market uncertainty over any regulatory or legislative initiatives that may affect the financial backing of these securities or other matters related to these agency securities. The securities issued by non-governmental entities are investment grade.

### Loans

Loans, net of unearned discounts increased 3.7% to \$5,740,914,000 at September 30, 2008, from \$5,536,628,000 at December 31, 2007. The increase in loans can be attributed to the Company's internal efforts to grow its loan balances.

## Deposits

Deposits decreased 2.2% to \$7,001,356,000 at September 30, 2008, from \$7,157,606,000 at December 31, 2007.

## Foreign Operations

On September 30, 2008, the Company had \$11,544,596,000 of consolidated assets, of which approximately \$284,401,000, or 2.5%, was related to loans outstanding to borrowers domiciled in foreign countries, compared to \$285,008,000, or 2.6%, at December 31, 2007. Of the \$284,401,000, 76.9% is directly or indirectly secured by U.S. assets, certificates of deposits and real estate; 22.3% is secured by foreign real estate; and 0.8% 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 notes 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 10-K for further information regarding the Company's provision and allowance for possible loan losses policy.

## 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 2008 and 2007 were 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

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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, 2008, shareholders' equity was \$995,073,000 compared to \$935,905,000 at December 31, 2007, an increase of \$59,168,000, or 6.3%. The increase is primarily due to the retention of earnings offset by dividends paid to shareholders.

The Company had a leverage ratio of 8.22% and 7.76%, risk-weighted Tier 1 capital ratio of 12.20% and 11.98% and risk-weighted total capital ratio of 13.20% and 12.99% at September 30, 2008 and December 31, 2007, respectively. The identified intangibles and goodwill of \$310,142,000 as of September 30, 2008, 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 of September 30, 2008, the Company had capital ratios in excess of those required to be considered well-capitalized under current banking regulations; however, given the substantial ongoing economic uncertainties and the lack of liquidity in the market, the Company believes it may be beneficial and prudent to raise capital under the U.S. Treasury's Capital Purchase Program. The Company believes that it would be eligible to raise up to approximately \$216 million of capital under the program and that the cost and amount of capital being offered under the Treasury's program may be significantly larger and more attractive than the capital otherwise available to the Company in the current market. Raising capital under the Treasury's program would provide the Company with an additional layer of capital to face the challenging economic environment and to participate in the opportunities that it may present. Participation in the Capital Purchase Program would require the Company to issue shares of preferred stock. The Company has called a special shareholders meeting in December 2008, for the shareholders to consider and vote on a proposal to authorize preferred stock 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, 2008 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**



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(Dollars in Thousands)

September 30, 2008	3 Months or Less	Over 3 Months to 1 Year	Rate/Maturity Over 1 Year to 5 Years	Over 5 Years	Total
<b>Rate sensitive assets</b>					
Federal funds sold	\$ 60,000	\$	\$	\$	\$ 60,000
Time deposits with banks	396				396
Investment securities	516,265	1,759,953	1,987,997	60,304	4,324,519
Loans, net of non-accruals	4,205,877	309,669	453,480	685,197	5,654,223
<b>Total earning assets</b>	<b>\$ 4,782,538</b>	<b>\$ 2,069,622</b>	<b>\$ 2,441,477</b>	<b>\$ 745,501</b>	<b>\$ 10,039,138</b>
<b>Cumulative earning assets</b>	<b>\$ 4,782,538</b>	<b>\$ 6,852,160</b>	<b>\$ 9,293,637</b>	<b>\$ 10,039,138</b>	
<b>Rate sensitive liabilities</b>					
Time deposits	\$ 1,436,252	\$ 1,555,069	\$ 320,920	\$ 595	\$ 3,312,836
Other interest bearing deposits	2,227,956				2,227,956
Securities sold under repurchase agreements	376,822	85,054	6,130	1,000,000	1,468,006
Other borrowed funds	1,624,750				1,624,750
Junior subordinated deferrable interest debentures	61,858		128,868	10,313	201,039
<b>Total interest bearing liabilities</b>	<b>\$ 5,727,638</b>	<b>\$ 1,640,123</b>	<b>\$ 455,918</b>	<b>\$ 1,010,908</b>	<b>\$ 8,834,587</b>
<b>Cumulative sensitive liabilities</b>	<b>\$ 5,727,638</b>	<b>\$ 7,367,761</b>	<b>\$ 7,823,679</b>	<b>\$ 8,834,587</b>	
Repricing gap	\$ (945,100)	\$ 429,499	\$ 1,985,559	\$ (265,407)	\$ 1,204,551
Cumulative repricing gap	(945,100)	(515,601)	1,469,958	1,204,551	
Ratio of interest-sensitive assets to liabilities	.83	1.26	5.36	.74	1.14
Ratio of cumulative, interest-sensitive assets to liabilities	.83	.93	1.19	1.14	

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

During the first nine months of 2008, there were no material changes in market risk exposures that affected the quantitative and qualitative disclosures regarding market risk presented under the caption "Liquidity and Capital Resources" located on pages 18 through 22 of the Company's 2007 Annual Report as filed as an exhibit to the Company's Form 10-K for the year ended December 31, 2007.

**Item 4. Controls and Procedures**

*Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within specified time periods. As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's principal executive officer and principal financial officer evaluated, with the participation of the Company's management, the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)). Based on the evaluation, which disclosed no material weaknesses, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

*Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

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 issued a 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 FPAA's.

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 FPAA's 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. The case was tried over nine days beginning August 29, 2005. On March 31, 2006, the trial court rendered a judgment against the Company on the first FPAA. IBC timely filed its notice of appeal to the Fifth Circuit Court of Appeals. The appeal was argued on August 8, 2007 and the Trial Court decision was affirmed on August 23, 2007. The judgment became non-appealable on November 21, 2007. The other partnership case was stayed by the same Trial Court pending the appeal. Following the resolution of the first case, the trial court reopened the second case and set it for trial on September 2, 2008. Subsequently, the Company engaged in settlement negotiations with the Department of Justice, and agreed to settle the second case. Under the terms of the settlement, the Company has conceded the entire amount in dispute based upon the similarity of the facts of that case to the first case and the likelihood of an unfavorable outcome if litigated based upon the Court rulings in the first case. On August 13, 2008, the Company filed a lawsuit in the Texas State District Court in Laredo, Texas against KPMG, LLP and a number of other

third parties asserting claims against the defendants related to the underlying transactions of the two partnership tax cases.

The Company, through December 31, 2005, had previously expensed approximately \$12.0 million in connection with the lawsuits. Because of the above-referenced trial court judgment against the Company on the first FPAA and the similarity between the two FPAA's, the Company additionally expensed an approximate \$13.7 million in the first quarter of 2006. The resultant approximately \$25.7 million expensed is the total of the tax adjustments due and the interest due on such adjustments for both FPAA's. Management will continue to evaluate the correspondence with the IRS on the FPAA's and make any appropriate revisions to the amounts as deemed necessary.

## **1A. Risk Factors**

Except for the addition of the risk factor detailed below, there were no material changes in the risk factors as previously disclosed in Item 1A to Part I of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007. Please also see the risk factors set forth under Special Cautionary Notice Regarding Forward Looking Information in Part I, Item 2, hereof entitled Management's Discussion and Analysis of Financial Condition and Results of Operations.

### *The Company May Be Adversely Affected by the Soundness of Other Financial Institutions*

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. The Company has exposure to many different industries and counterparties, and routinely engages in transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose the Company to credit risk in the event of a default by a counterparty or client, including credit risk related to the underlying collateral of such transactions. Any such losses could have a material adverse affect on the Company's financial conditions and results of operations.

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

The Company expanded its formal stock repurchase program on May 3, 2007. Under the expanded stock repurchase program, the Company is authorized to repurchase up to \$225,000,000 of its common stock through December 2008. 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 November 3, 2008, a total of 6,200,226 shares had been repurchased under this program at a cost of \$213,005,000. 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 \$245,973,000. 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 \$245,973,000 cap will occur in the future. As of November 3, 2008, the Company has approximately \$233,978,000 invested in treasury shares, which amount has been accumulated since the inception of the Company.

Share repurchases are only conducted under publicly announced repurchase programs approved by the Board of Directors. The following table includes information about share repurchases for the quarter ended September 30, 2008.

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		<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>	<b>Shares Purchased as Part of a Publicly- Announced Program</b>	<b>Approximate Dollar Value of Shares Available for Repurchase (1)</b>
July 1	July 31, 2008				\$ 12,076,800
August 1	August 31, 2008				12,076,800
September 1	September 30, 2008	1,625	29.29		12,029,200
		1,625	\$ 29.29		

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(1) The formal stock repurchase program was initiated in 1999 and has been expanded periodically with the most recent expansion occurring in May 2007. The current program allows for the repurchase of up to \$225,000,000 of treasury stock through December 2008 of which \$12,029,200 remains.

**Item 6. Exhibits**

The following exhibits are filed as a part of this Report:

31(a) Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31(b) Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32(a) Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32(b) Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

INTERNATIONAL BANCSHARES CORPORATION

Date: November 7, 2008

/s/ Dennis E. Nixon  
Dennis E. Nixon  
President

Date: November 7, 2008

/s/ Imelda Navarro  
Imelda Navarro  
Treasurer