

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

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2005

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-14517

**TEXAS REGIONAL BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

[www.trbsinc.com](http://www.trbsinc.com)

Texas

(State or other jurisdiction  
of incorporation or organization)

74-2294235

(I.R.S. Employer  
Identification No.)

3900 North 10<sup>th</sup> Street, 11<sup>th</sup> Floor  
McAllen, Texas 78501

(Address of principal executive offices) (Zip Code)

(956) 631-5400

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

There were 49,693,025 shares of the registrant's Class A Voting Common Stock, \$1.00 par value, outstanding as of November 7, 2005.

## PART I - FINANCIAL INFORMATION

### ITEM 1. Financial Statements

Texas Regional Bancshares, Inc. and Subsidiaries  
Condensed Consolidated Balance Sheets  
(Dollars in Thousands, Except Share Data)

	September 30, 2005	December 31, 2004
	(Unaudited)	
<b>Assets</b>		
Cash and Due From Banks	\$ 138,986	\$ 145,528
Interest-Bearing Deposits at Other Banks	858	779
<b>Total Cash and Cash Equivalents</b>	<b>139,844</b>	<b>146,307</b>
Time Deposits	-	8
Securities Available for Sale, at Fair Value	1,757,143	1,530,503
Securities Held to Maturity, at Amortized Cost (Fair Value of \$0 in 2005 and \$215 in 2004)	-	210
Loans Held for Sale, Net of Unearned Discount of \$14 in 2005 and \$17 in 2004	22,754	28,982
Loans Held for Investment, Net of Unearned Discount of \$129 in 2005 and \$376 in 2004	3,965,628	3,750,519
Less: Allowance for Loan Losses	(51,368)	(45,024)
<b>Net Loans Held for Investment</b>	<b>3,914,260</b>	<b>3,705,495</b>
Premises and Equipment, Net	147,084	134,239
Accrued Interest Receivable	39,917	36,082
Other Real Estate	8,143	6,223
Goodwill	192,729	174,503
Identifiable Intangibles, Net	27,224	29,607
Other Assets	54,374	47,188
<b>Total Assets</b>	<b>\$6,303,472</b>	<b>\$5,839,347</b>
<b>Liabilities</b>		
<b>Deposits</b>		
Demand	\$ 907,280	\$ 866,773
Savings	208,186	211,825
Money Market Checking and Savings	1,650,553	1,440,207
Time Deposits	2,363,455	2,242,035
<b>Total Deposits</b>	<b>5,129,474</b>	<b>4,760,840</b>
Other Borrowed Money	499,177	461,751
Accounts Payable and Accrued Liabilities	43,300	22,698
<b>Total Liabilities</b>	<b>5,671,951</b>	<b>5,245,289</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders' Equity</b>		
Preferred Stock; \$1.00 Par Value, 10,000,000 Shares Authorized; None Issued and Outstanding	-	-
Common Stock – Class A; \$1.00 Par Value, Authorized 100,000,000 in 2005 and 50,000,000 Shares in 2004; Issued 49,708,384 Shares in 2005 and 49,574,900 Shares in 2004	Shares 49,708	49,575
Paid-In Capital	403,924	401,414
Retained Earnings	194,685	146,020
Accumulated Other Comprehensive Loss, Net of Tax	(16,057)	(2,212)
Treasury Stock; 21,780 Shares in 2005 and 2004, at Cost	(739)	(739)
<b>Total Shareholders' Equity</b>	<b>631,521</b>	<b>594,058</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$6,303,472</b>	<b>\$5,839,347</b>

The accompanying notes are an integral part of the condensed consolidated financial statements.

Texas Regional Bancshares, Inc. and Subsidiaries  
Condensed Consolidated Statements of Income and  
Comprehensive Income  
(Dollars in Thousands, Except Per Share Data)

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2005	2004	2005	2004
	(Unaudited)			
Interest Income				
Loans Held for Sale	\$ 406	\$ 180	\$ 1,057	\$ 685
Loans Held for Investment, Including Fees	74,803	57,969	210,969	157,259
Securities				
Taxable	14,988	12,252	42,198	34,887
Tax-Exempt	1,441	1,147	3,835	3,215
Interest-Bearing and Time Deposits	10	2	44	45
Federal Funds Sold	86	7	261	35
<b>Total Interest Income</b>	<b>91,734</b>	<b>71,557</b>	<b>258,364</b>	<b>196,126</b>
Interest Expense				
Deposits	27,731	15,638	72,249	42,261
Federal Funds Purchased and Securities				
Sold Under Repurchase Agreements	595	549	1,743	1,597
Federal Home Loan Bank Advances	2,559	626	5,869	1,308
Other Borrowed Money	1,203	923	3,364	2,302
<b>Total Interest Expense</b>	<b>32,088</b>	<b>17,736</b>	<b>83,225</b>	<b>47,468</b>
Net Interest Income Before Provision for Loan Losses	59,646	53,821	175,139	148,658
Provision for Loan Losses	8,720	6,197	19,928	14,813
<b>Net Interest Income After Provision for Loan Losses</b>	<b>50,926</b>	<b>47,624</b>	<b>155,211</b>	<b>133,845</b>
Noninterest Income				
Service Charges on Deposit Accounts	10,082	10,530	28,863	28,092
Other Service Charges	2,701	2,194	8,356	6,404
Insurance Commissions, Fees and Premiums, Net	997	1,173	2,974	2,546
Trust Fees	1,892	1,674	5,636	3,845
Net Realized Gains on Sales of Securities				
Available for Sale	475	2,963	796	4,845
Data Processing Service Fees	2,159	2,080	6,931	6,330
Loan Servicing Loss, Net	(352)	(677)	(196)	(1,138)
Other Noninterest Income	1,894	658	12,252	2,010
<b>Total Noninterest Income</b>	<b>19,848</b>	<b>20,595</b>	<b>65,612</b>	<b>52,934</b>
Noninterest Expense				
Salaries and Employee Benefits	21,886	20,372	64,213	53,577
Net Occupancy Expense	3,749	3,136	10,905	8,608
Equipment Expense	3,515	3,222	10,448	9,184
Other Real Estate (Income) Expense, Net	305	(57)	952	636
Amortization of Identifiable Intangibles	1,514	1,987	5,007	4,387
Other Noninterest Expense, Net	9,903	9,624	29,441	27,044
<b>Total Noninterest Expense</b>	<b>40,872</b>	<b>38,284</b>	<b>120,966</b>	<b>103,436</b>
Income Before Income Tax Expense	29,902	29,935	99,857	83,343
Income Tax Expense	10,073	10,114	34,315	27,533
<b>Net Income</b>	<b>19,829</b>	<b>19,821</b>	<b>65,542</b>	<b>55,810</b>
Other Comprehensive Income (Loss), Net of Tax				
Net Unrealized Gains (Losses) on Securities Available for Sale				
Net Unrealized Holding Gains (Losses) Arising During Period	(4,859)	17,310	(13,328)	(2,694)
Less: Reclassification Adjustment for Net Realized Gains				
Included in Net Income	309	1,926	517	3,149
<b>Total Other Comprehensive Income (Loss)</b>	<b>(5,168)</b>	<b>15,384</b>	<b>(13,845)</b>	<b>(5,843)</b>
<b>Comprehensive Income</b>	<b>\$ 14,661</b>	<b>\$ 35,205</b>	<b>\$ 51,697</b>	<b>\$ 49,967</b>
Earnings Per Common Share				
Basic	\$ 0.40	\$ 0.41	\$ 1.32	\$ 1.17
Diluted	0.40	0.40	1.31	1.16

The accompanying notes are an integral part of the condensed consolidated financial statements.

Texas Regional Bancshares, Inc. and Subsidiaries Condensed Consolidated Statements of Changes in Shareholders' Equity (Dollars in Thousands)	Common		Retained Earnings	Accumulated Other	Treasury Stock	Total Shareholders' Equity
	Stock - Class A	Paid-In Capital		Comprehensive Income (Loss)		
(Unaudited)						
Nine Months Ended September 30, 2005						
Balance, December 31, 2004	\$49,575	\$401,414	\$146,020	\$ (2,212)	\$(739)	\$594,058
Net Income	-	-	65,542	-	-	65,542
Net Change in Unrealized Gains and Losses on Securities Available for Sale, Net of Tax and Reclassification Adjustment	-	-	-	(13,845)	-	(13,845)
<b>Total Comprehensive Income</b>	<b>-</b>	<b>-</b>	<b>65,542</b>	<b>(13,845)</b>	<b>-</b>	<b>51,697</b>
Exercise of Stock Options, 133,484 Shares of Class A Common Stock	133	2,114	-	-	-	2,247
Tax Effect of Nonqualified Stock Options Exercised and Disqualifying Dispositions on Qualified Stock Options	-	396	-	-	-	396
Class A Common Stock Cash Dividends	-	-	(16,877)	-	-	(16,877)
<b>Balance, September 30, 2005</b>	<b>\$49,708</b>	<b>\$403,924</b>	<b>\$194,685</b>	<b>\$(16,057)</b>	<b>\$(739)</b>	<b>\$631,521</b>
Nine Months Ended September 30, 2004						
Balance, December 31, 2003	\$29,471	\$278,131	\$103,773	\$ 10,356	\$ -	\$421,731
Net Income	-	-	55,810	-	-	55,810
Net Change in Unrealized Gains and Losses on Securities Available for Sale, Net of Tax and Reclassification Adjustment	-	-	-	(5,843)	-	(5,843)
<b>Total Comprehensive Income</b>	<b>-</b>	<b>-</b>	<b>55,810</b>	<b>(5,843)</b>	<b>-</b>	<b>49,967</b>
Exercise of Stock Options, 105,359 Shares of Class A Common Stock	105	2,146	-	-	-	2,251
Tax Effect of Nonqualified Stock Options Exercised and Disqualifying Dispositions on Qualified Stock Options	-	510	-	-	-	510
Three-For-Two Stock Split	16,311	-	(16,348)	-	-	(37)
Issuance of Common Stock	3,073	107,001	-	-	-	110,074
Class A Common Stock Cash Dividends	-	-	(13,105)	-	-	(13,105)
<b>Balance, September 30, 2004</b>	<b>\$48,960</b>	<b>\$387,788</b>	<b>\$130,130</b>	<b>\$ 4,513</b>	<b>\$ -</b>	<b>\$571,391</b>

The accompanying notes are an integral part of the condensed consolidated financial statements.

Texas Regional Bancshares, Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows  
(Dollars in Thousands)

Nine Months  
Ended September 30,  
2005      2004

	(Unaudited)	
<b>Cash Flows from Operating Activities</b>		
Net Income	\$ 65,542	\$ 55,810
Adjustments to Reconcile Net Income to		
Net Cash Provided by Operating Activities		
Depreciation, Amortization and Accretion	22,117	22,790
Provision for Loan Losses	19,928	14,813
Provision for Estimated Losses on Other Real Estate and Other Assets	119	966
Decrease in Valuation Allowance for Mortgage Servicing Rights	-	(686)
Net Realized Gains on Sale of Securities Available for Sale	(796)	(4,845)
(Gain) Loss on Sale of Other Assets	90	(80)
(Gain) Loss on Sale of Other Real Estate	137	(195)
Gain on Disposal of Premises and Equipment	(29)	(4)
Gain on Sale of Loans Held for Sale	(2,606)	(98)
Gain on Sale of Mortgage Servicing Rights	(1,447)	-
Net Decrease in Loans Held for Sale	8,834	6,644
Deferred Tax Benefit	(4,784)	(2,379)
Increase in Accrued Interest Receivable and Other Assets	(2,125)	(295)
Increase in Accounts Payable and Accrued Liabilities	7,382	4,716
<b>Net Cash Provided by Operating Activities</b>	<b>112,362</b>	<b>97,157</b>
<b>Cash Flows from Investing Activities</b>		
Net Decrease in Time Deposits at Other Banks	8	188
Proceeds from Sales of Securities Available for Sale	133,765	319,178
Proceeds from Maturing Securities Available for Sale	139,331	126,160
Purchases of Securities Available for Sale	(512,290)	(464,447)
Proceeds from Maturing Securities Held to Maturity	210	200
Loan Originations and Advances, Net	(122,854)	(346,822)
Recoveries of Charged-Off Loans	1,752	1,938
Proceeds from Sale of Premises and Equipment	31	321
Purchases of Premises and Equipment	(14,570)	(15,874)
Proceeds from Sale of Other Real Estate	4,805	3,943
Proceeds from Sale of Other Assets	1,586	1,122
Net Cash Provided by Merger	20,406	71,571
<b>Net Cash Used in Investing Activities</b>	<b>(347,820)</b>	<b>(302,522)</b>
<b>Cash Flows from Financing Activities</b>		
Net Increase in Demand Deposits, Savings, Money		
Market Checking and Savings Accounts	108,446	72,190
Net Increase in Time Deposits	86,745	16,535
Net Increase in Other Borrowed Money	47,426	164,540
Cash Dividends Paid on Class A Common Stock	(15,869)	(11,740)
Cash Paid in Lieu of Fractional Shares	-	(37)
Proceeds from Sale of Common Stock	2,247	2,251
<b>Net Cash Provided by Financing Activities</b>	<b>228,995</b>	<b>243,739</b>
Increase (Decrease) in Cash and Cash Equivalents	(6,463)	38,374
Cash and Cash Equivalents at Beginning of Period	146,307	100,723
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ 139,844</b>	<b>\$ 139,097</b>

(Continued)

Texas Regional Bancshares, Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows  
(Dollars in Thousands)

Nine Months  
Ended September 30,

2005 2004

(Unaudited)

Supplemental Disclosures of Cash Flow Information:

Interest Paid	\$ 79,802	\$ 46,170
Income Taxes Paid	35,155	30,403

Supplemental Schedule of Noncash Investing and Financing Activities:

Foreclosure and Repossession in Partial Satisfaction of Loans Receivable	12,931	4,684
Financing Provided for Sales of Other Real Estate	3,917	2,339
Increase in Securities Purchased But Not Settled	13,781	8,370
Increase in Securities Sold But Not Settled	962	32,399
Increase in Other Real Estate Sold But Not Settled	481	-
Net Increase in Dividends Payable	1,008	1,365

The Company acquired Mercantile Bank & Trust, FSB, on January 14, 2005.

Assets acquired and liabilities assumed are as follows:

Fair Value of Assets Acquired, Including Goodwill, Net of Cash and Cash Equivalents Received	144,464	-
Net Cash and Cash Equivalents Received	20,430	-
Fair Value of Liabilities Assumed	164,894	-

The Company acquired Southeast Texas Bancshares, Inc. and its subsidiary,  
Community Bank and Trust, SSB, on March 12, 2004.

Assets acquired and liabilities assumed are as follows:

Fair Value of Assets Acquired Including Goodwill, Net of Cash and Cash Equivalents Received	-	1,028,098
Net Cash and Cash Equivalents Received	-	71,571
Fair Value of Liabilities Assumed	-	989,595
Fair Value of Stock Issued	-	110,074

The accompanying notes are an integral part of the condensed consolidated financial statements.

**TEXAS REGIONAL BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1: BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all information and notes necessary for a complete presentation of financial position, results of operations, changes in shareholders' equity, and cash flows in conformity with U.S. generally accepted accounting principles. However, the condensed consolidated financial statements include all adjustments that, in the opinion of management, are necessary for a fair presentation. All such adjustments were of a normal and recurring nature. The results of operations and cash flows for the nine months ended September 30, 2005 should not be considered indicative of the results to be expected for the full year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Texas Regional Bancshares, Inc. and Subsidiaries ("Texas Regional" or the "Company") Annual Report on Form 10-K for the year ended December 31, 2004.

The condensed consolidated financial statements include the accounts of Texas Regional Bancshares, Inc. (the "Parent") and its wholly-owned subsidiaries, Texas Regional Delaware, Inc., Texas State Bank (the "Bank"), Southeast Texas Insurance Services, L.P., operating under the name Community Insurance, Port Arthur Abstract and Title Company, Southeast Texas Title Company, TSB Securities, Inc., TSB Properties, Inc., Hydrox Holdings, Inc. and Valley Mortgage Company, Inc. ("Valley Mortgage"). The Company eliminates all significant intercompany transactions and balances in consolidation. The Company accounts for its investments in subsidiaries on the equity method in the Parent's financial statements.

**NEW ACCOUNTING PRONOUNCEMENTS**

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position 03-3 ("SOP 03-3"), "Accounting for Certain Loans or Debt Securities Acquired in a Transfer". SOP 03-3 provides guidance on the accounting for differences between contractual and expected cash flows from the purchaser's initial investment in loans or debt securities acquired in a transfer, if those differences are attributable, at least in part, to credit quality. Among other things, SOP 03-3: (1) prohibits the recognition of the excess of contractual cash flows over expected cash flows as an adjustment of yield, loss accrual, or valuation allowance at the time of purchase; (2) requires that subsequent increases in expected cash flows be recognized prospectively through an adjustment of yield; and (3) requires the subsequent decreases in expected cash flows be recognized as an impairment. In addition, SOP 03-3 prohibits the creation or carrying over of a valuation allowance in the initial accounting of all loans within its scope that are acquired in a transfer. SOP 03-3 was adopted during first quarter 2005.

In December 2004, the Financial Accounting Standards Board issued Statement No. 123 (revised 2004) ("Statement 123R") "Share-Based Payment", a revision of Statement No. 123 ("Statement 123"), "Accounting for Stock-Based Compensation". This statement supersedes Accounting Principles Board Opinion No. 25 ("Opinion 25"), "Accounting for Stock Issued to Employees". Statement 123R eliminates an entity's ability to report employee stock options under the methods prescribed by Opinion 25. Statement 123R establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services or incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. This statement requires entities to recognize the cost of employee services received in exchange for an award of equity instruments, based on the grant-date fair value of the awards. In April 2005, the Securities and Exchange Commission amended the required effective date of Statement 123R. Statement 123R will be effective as of the first interim or annual reporting period of the first fiscal year beginning on or after June 15, 2005.

Statement 123R provides alternative methods of adoption which include using either a "modified prospective application" or a "modified retrospective application". The "modified prospective application" requires the recognition of compensation cost, beginning with the effective date, for all awards granted after the adoption date based on the requirements of Statement 123R and for all unvested awards granted prior to the adoption date of Statement 123R, based on the requirements of Statement 123. The "modified retrospective application" includes the requirements of the "modified prospective application", but also permits the restatement of financial statements of previous periods based on amounts previously disclosed in accordance with Statement 123. The Company is currently evaluating the adoption alternatives. Based on stock options granted to employees through September 30, 2005, for which service is not expected to be fully rendered prior to January 1, 2006, the Company expects to recognize additional pre-tax compensation costs of approximately \$1,643,000 during 2006 as a result of the adoption of Statement 123R effective January 1, 2006. Future levels of compensation cost related to stock-based compensation awards will be impacted by new stock option awards by the Company occurring before and after the adoption of Statement 123R.

In May 2005, the Financial Accounting Standards Board issued Statement No. 154 ("Statement 154"), "Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3". This statement replaces Accounting Principles Board Opinion No. 20 ("Opinion 20"), "Accounting Changes" and Financial Accounting Standards Board Statement No. 3 ("Statement 3"), "Reporting Accounting Changes in Interim Financial Statements – an amendment of APB Opinion No. 28", and changes the requirements for the accounting for and reporting of a change in accounting principle. This

statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. Opinion 20 required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. Statement 154 will require companies to recognize a change in accounting principle by applying that change retrospectively to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. Statement 154 also makes a distinction between "retrospective application" of an accounting principle and the "restatement" of financial statements to reflect the correction of an error. Statement 154 also requires that a change in depreciation, amortization or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will assess the impact of a retrospective application of a change in accounting principle in accordance with Statement 154 should such a change arise after the effective date.

#### STOCK BASED EMPLOYEE COMPENSATION

The Company has accounted for its stock-based compensation plans in accordance with the intrinsic value provisions of Accounting Principles Board Opinion No. 25 ("Opinion 25"), "Accounting for Stock Issued to Employees". As indicated above, the Company will adopt Statement 123R, which supersedes Opinion 25, beginning January 1, 2006. Under Opinion 25, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. All outstanding options have been granted at fair market value at date of grant; therefore, the Company did not record any compensation expense in the condensed consolidated financial statements for its stock-based compensation plans. In accordance with Statement 148, the following table illustrates the effect on net income and earnings per common share had compensation expense been recognized consistent with the fair value provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (dollars in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Unaudited)			
Net Income, As Reported	\$19,829	\$19,821	\$65,542	\$55,810
Deduct: Total Stock-Based Employee Compensation Expense Determined Under Fair Value Based Method For All Awards, Net of Related Tax Effect	(752)	(758)	(2,267)	(1,929)
<b>Pro Forma Net Income</b>	<b>\$19,077</b>	<b>\$19,063</b>	<b>\$63,275</b>	<b>\$53,881</b>
<b>Earnings Per Common Share:</b>				
Basic – As Reported	\$ 0.40	\$ 0.41	\$ 1.32	\$ 1.17
Basic – Pro Forma	0.38	0.39	1.28	1.13
Diluted – As Reported	0.40	0.40	1.31	1.16
Diluted – Pro Forma	0.38	0.39	1.27	1.12

#### NOTE 2: IMPAIRED LOANS

Loans that the Company does not expect to collect the full principal and interest based on the terms of the original loan agreement are identified as impaired loans. These include loans that are on nonaccrual status or are considered troubled debt restructurings due to the granting of a below-market rate of interest or a partial forgiveness of indebtedness on an existing loan. The balance of impaired loans was \$40,556,000 at September 30, 2005 for which there was a related allowance for loan losses of \$8,962,000. At September 30, 2005, the balance of impaired loans included \$178,000 for which there was no related allowance for loan losses. The average recorded investment in impaired loans during the nine months ended September 30, 2005 was \$35,538,000. Interest income on impaired loans of \$609,000 for cash payments received on nonaccrual loans was recognized during the nine months ended September 30, 2005.

NOTE 3: JUNIOR SUBORDINATED DEBENTURES

As of September 30, 2005, the Riverway Holdings Capital Trust I, Riverway Holdings Capital Trust II and the Texas Regional Statutory Trust I (the "Trusts"), all wholly-owned unconsolidated subsidiaries of Texas Regional Delaware, Inc., had the following trust preferred securities outstanding and the Company had the following issues of junior subordinated debentures, all held by the Trusts, outstanding (dollars in thousands):

Description	Issuance Date	Trust Preferred Securities Outstanding	Interest Rate	Junior Subordinated Debt Owed To Trust	Final Maturity Date
Riverway Holdings Capital Trust I	March 28, 2001	\$10,000	10.18% Fixed	\$10,310	June 8, 2031
Riverway Holdings Capital Trust II	July 16, 2001	5,000	6-month LIBOR plus 3.75%	5,155	July 25, 2031
Texas Regional Statutory Trust I	February 24, 2004	50,000	3-month LIBOR plus 2.85%	51,547	March 17, 2034

The Company owns all of the common stock of the three business trusts, which have issued trust preferred securities in conjunction with the Company and an acquired company issuing junior subordinated debentures to the Trusts. The terms of the junior subordinated debentures are substantially the same as the terms of the trust preferred securities. The Company's obligations under the debentures constitute a full and unconditional guarantee by the Company of the obligations of the Trusts. The junior subordinated debentures issued to the Trusts are included as other borrowed money in the condensed consolidated balance sheets.

On March 1, 2005, the Federal Reserve Board issued a final rule that allows the continued limited inclusion of trust preferred securities in the Tier 1 capital of bank holding companies. Under the rule, trust preferred securities and other restricted core capital elements will be subject to stricter quantitative limits. The final rule provides a five-year transition period ending March 31, 2009, for application of the quantitative limits. The Company's trust preferred securities are fully included in Tier 1 Capital as permitted by the Federal Reserve's final rule.

NOTE 4: COMMON STOCK

On March 8, 2005, the Board of Directors approved a cash dividend of \$0.10 per share for shareholders of record on April 1, 2005 and payable on April 15, 2005. In addition, on June 14, 2005, the Board of Directors approved a cash dividend of \$0.12 per share for shareholders of record on July 1, 2005 and payable on July 15, 2005. On September 13, 2005, the Board of Directors approved a cash dividend of \$0.12 per share for shareholders of record on September 30, 2005 and payable on October 14, 2005.

NOTE 5: EARNINGS PER COMMON SHARE COMPUTATIONS

The table below presents a reconciliation of basic and diluted earnings per common share computations ("EPS") (dollars in thousands, except share data).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Unaudited)			
Net Income	\$ 19,829	\$ 19,821	\$ 65,542	\$ 55,810
Weighted Average Number of Common Shares Outstanding				
Used in Basic EPS Calculation	49,646,423	48,921,063	49,607,989	47,658,905
Add Assumed Exercise of Dilutive Securities				
Outstanding Stock Options	272,313	331,426	270,638	289,643
Riverway Holdback Shares	-	247,500	-	247,500
Weighted Average Number of Common Shares Outstanding Used in Diluted EPS Calculation	49,918,736	49,499,989	49,878,627	48,196,048
Basic EPS	\$ 0.40	\$ 0.41	\$ 1.32	\$ 1.17
Diluted EPS	0.40	0.40	1.31	1.16

#### NOTE 6: RECENT ACQUISITION

On January 14, 2005, the Company completed the acquisition through merger of Mercantile Bank & Trust, FSB ("Mercantile"). Mercantile was a privately held Federal savings bank headquartered in Dallas, Texas, with two additional banking locations in the Dallas metropolitan area. The shareholders of Mercantile received \$35,640,000 in cash in exchange for all the outstanding shares of Mercantile. Mercantile had total assets of \$213.8 million, loans held for investment of \$118.1 million, deposits of \$197.5 million and equity of \$14.7 million. The transaction was accounted for under the purchase method of accounting; therefore, the results of operations are included in the condensed consolidated financial statements from the date of acquisition, January 14, 2005. The proforma effect and the financial results of Mercantile included in the results of operations subsequent to the date of acquisition were not material to the Company's financial condition or the operating results for the periods presented. Mercantile was merged with and into the Bank.

#### NOTE 7: HURRICANE RITA

Hurricane Rita struck the East Texas Coast on September 24, 2005. As the storm approached the Gulf Coast, several coastal areas were subject to mandatory evacuations and the Company closed banking centers and other offices from Corpus Christi to the Texas-Louisiana border at noon on September 22, 2005. The Company's banking centers in Corpus Christi, Houston, San Augustine and Tyler reopened on Monday, September 26, 2005. As of November 7, 2005, only one motor bank and two small banking centers, all located in East Texas, had not reopened. The estimated expenditures, expected insurance proceeds, any loan related losses, any asset related gains or losses and the estimated damage related expenses are all subject to substantial uncertainties and will change as additional information becomes available.

The Company recorded an additional provision to the allowance for loan losses of \$2,500,000 for probable losses on loans to borrowers affected by Hurricane Rita. In addition to the probable losses on loans, several of the Company's banking centers and offices located in East Texas were damaged by Hurricane Rita. The estimated cost of the damage to the facilities is \$1,000,000, substantially all of which is covered by insurance. As such, the Company reduced premises and equipment and recorded a receivable for insurance of \$1,000,000 at September 30, 2005.

#### NOTE 8: RECLASSIFICATIONS

Certain amounts in the prior periods' presentation have been reclassified to conform to the current presentation. These reclassifications have no effect on previously reported net income.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*Forward-Looking Statements.* This Management's Discussion and Analysis and other information in this Quarterly Report on Form 10-Q include forward-looking statements within the meaning of Section 27A of the Securities 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. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Such risks and uncertainties include, but are not limited to, the following factors: significant increases in competitive pressure in the banking industry; changes in the interest rate environment reducing margins; general economic conditions, either nationally or regionally, becoming less favorable than expected, resulting in, among other things, a deterioration in credit quality and an increase in the provision for possible loan losses; changes in the regulatory environment; changes in business conditions; volatility of rate sensitive deposits; operational risks including data processing system failures or fraud; asset/liability matching risks and liquidity risks; and changes in the securities markets. In addition to these risks and uncertainties, other risks and uncertainties potentially impacting Texas Regional are those related to Texas Regional's business in East Texas in the areas impacted by Hurricane Rita, including the continuing effect of the storm and its aftermath on the Company's operating expenses and on the Company's borrowers and other customers. Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. The Company assumes no obligation and does not intend to update these forward-looking statements. In addition, the Company's past results do not necessarily indicate its future results.

Management's discussion and analysis of the Company's condensed consolidated financial condition and results of operations at the dates and for the periods indicated follows. This discussion should be read in conjunction with the Company's condensed consolidated financial statements and the accompanying notes.

### GENERAL

Texas Regional Bancshares, Inc. is a Texas business corporation incorporated in 1983 and headquartered in McAllen, Texas. The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956 and as such is registered with the Board of Governors of the Federal Reserve System ("Federal Reserve Board"). Texas Regional Delaware, Inc. ("Texas Regional Delaware"), incorporated under the laws of Delaware as a wholly-owned second tier bank holding company subsidiary, owns Texas State Bank (the "Bank"), the Company's primary operating subsidiary. As a result of the

acquisition of Southeast Texas Bancshares, Inc. ("Southeast Texas") in March 2004, Texas Regional Delaware is now the owner, directly or indirectly, of all of the ownership interests in (i) Southeast Texas Insurance Services, L.P., which operates under the name of Community Insurance and offers general lines of insurance and (ii) Port Arthur Abstract and Title Company and its wholly-owned subsidiary, Southeast Texas Title Company, which offer title insurance agency services. The Bank has four active wholly-owned subsidiaries: (i) TSB Securities, Inc., incorporated in 1997 to provide full service broker-dealer services, (ii) TSB Properties, Inc., incorporated in 1998 primarily to receive and liquidate foreclosed assets, (iii) Hydrox Holdings, Inc., a subsidiary formed by an acquired institution to own and operate certain real estate properties and (iv) Valley Mortgage Company, Inc., a corporation acquired in November 2004 which operates a mortgage banking business in Texas.

By authority of the Board of Directors of the Company, Texas Regional in May 2000 filed a Declaration Electing to be a Financial Holding Company with the Federal Reserve Bank of Dallas. The Declaration became effective in June 2000.

Texas State Bank operates seventy-one banking offices. Thirty-one banking locations are located in the Rio Grande Valley including four banking locations in McAllen (including its main office), four banking locations in Brownsville, four banking locations in Harlingen, three banking locations in Mission, three banking locations in Weslaco, two banking locations in Edinburg, two banking locations in San Juan, and one banking location each in Hidalgo, La Feria, Mercedes, Palm Valley, Peñitas, Progreso, Raymondville, Rio Grande City, and Roma. In addition, Texas State Bank operates one banking location each in Bishop, Corpus Christi, Eagle Pass and Sugar Land, two banking locations in Houston and three banking locations in Dallas. Thirty-one banking locations are located in the East Texas area including seven banking locations in Beaumont, five banking locations in Port Arthur, two banking locations in Orange, two banking locations in Jasper, two banking locations in Lumberton, two banking locations in Silsbee, and one banking location each in Kountze, Port Neches, Sour Lake, Vidor, Tyler, Broaddus, Buna, Colmesneil, Kirbyville, San Augustine and Woodville. At September 30, 2005, Texas Regional had consolidated total assets of \$6,303,472,000, loans held for investment (net of unearned discount) of \$3,965,628,000, deposits of \$5,129,474,000 and shareholders' equity of \$631,521,000.

The Bank provides data processing services to correspondent banks. The Bank's data processing center serves banks both in North Texas and the Rio Grande Valley, in addition to providing data processing services for all of the Bank's banking locations.

## **CRITICAL ACCOUNTING POLICIES**

*Allowance for Loan Losses.* The Company considers its Allowance for Loan Losses and related provision for loan losses policy as a policy critical to the sound operations of the Bank. The Company provides for loan losses each period by an amount resulting from both (a) an estimate by management of probable loan losses that occurred during the period and (b) the ongoing adjustment of prior estimates of probable losses occurring in prior periods. The provision for loan losses increases the allowance for loan losses, which is netted against loans held for investment on the condensed consolidated balance sheets. As losses are confirmed, the loan is written down, reducing the allowance for loan losses. See "Allowance for Loan Losses - Critical Accounting Policy" and "Provision for Loan Losses" for further information regarding the Company's provision and allowance for loan losses policy.

*Mortgage Servicing Rights.* The Company also considers the accounting estimates used in evaluating the carrying value of the mortgage servicing rights to be critical. The Company evaluates the carrying value of the mortgage servicing rights for impairment based upon the fair value of those rights. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates, terms and type (fixed or adjustable). Fair value of mortgage servicing rights is determined by discounting the present value of the estimated future net servicing revenues using a discount rate commensurate with the risks involved based on management's best estimate of remaining loan lives. This method of valuation incorporates assumptions that market participants would use in their estimate of future servicing income and expense, including assumptions about prepayments, defaults and interest rates. At September 30, 2005, the fair value was based on the present value of future cash flows using prepayment rates ranging from 85% to 400% of standard Public Securities Association prepayment rates, discount rates ranging from 8% to 20% and weighted average lives ranging from 3 to 10 years.

## **FINANCIAL CONDITION**

### **CASH AND CASH EQUIVALENTS**

The Company offers a broad range of commercial banking services to individuals and businesses in its service area. It also acts as a correspondent to a number of banks in its service area, providing check clearing, loan participations and other correspondent services. The amount of cash and cash equivalents held on any day is significantly influenced by temporary changes in cash items in process of collection. The Company had cash and cash equivalents totaling \$139,844,000 at September 30, 2005. By comparison, the Company had \$146,307,000 in cash and cash equivalents at December 31, 2004, a decrease of \$6,463,000 or 4.4%.

### **SECURITIES**

Securities consist of U.S. Treasury, U.S. Government Agency, mortgage-backed and state, county and municipal securities. The Bank classifies debt and equity securities into one of three categories: held to maturity, trading or available for sale. At each reporting date, management reassesses the appropriateness of the classification. Investments in debt securities are classified as

held to maturity and measured at amortized cost in the condensed consolidated balance sheets only if management has the positive intent and ability to hold those securities to maturity. Securities that are bought and held principally for the purpose of selling them in the near term are classified as trading and measured at fair value in the condensed consolidated balance sheets with unrealized holding gains and losses included in earnings. Securities not classified as either held to maturity or trading are classified as available for sale and measured at fair value in the condensed consolidated balance sheets with unrealized holding gains and losses reported in accumulated other comprehensive income (loss), net of applicable income taxes, until realized.

At September 30, 2005 and December 31, 2004, no securities were classified as trading. The Company does not currently engage in trading activities or use derivative instruments to control interest rate risk. Even though such activities may be permitted with the approval of the Board of Directors, the Company does not intend to engage in such activities in the immediate future.

The following table presents the amortized cost and estimated fair value of securities at September 30, 2005 and December 31, 2004 (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Securities Available for Sale</b>				
September 30, 2005 (Unaudited)				
U.S. Treasury	\$ 5,545	\$ -	\$ (112)	\$ 5,433
U.S. Government Agency	843,145	938	(13,686)	830,397
Mortgage-Backed	717,336	40	(12,229)	705,147
States and Political Subdivisions	168,332	1,457	(1,165)	168,624
Other	47,780	18	(256)	47,542
<b>Total</b>	<b>\$1,782,138</b>	<b>\$2,453</b>	<b>\$(27,448)</b>	<b>\$1,757,143</b>
December 31, 2004				
U.S. Treasury	\$ 6,110	\$ -	\$ (65)	\$ 6,045
U.S. Government Agency	789,514	2,837	(6,508)	785,843
Mortgage-Backed	547,505	1,593	(3,788)	545,310
States and Political Subdivisions	149,073	2,967	(583)	151,457
Other	41,780	79	(11)	41,848
<b>Total</b>	<b>\$1,533,982</b>	<b>\$7,476</b>	<b>\$(10,955)</b>	<b>\$1,530,503</b>
<b>Securities Held to Maturity</b>				
September 30, 2005 (Unaudited)				
	\$ -	\$ -	\$ -	\$ -
December 31, 2004				
States and Political Subdivisions	\$ 210	\$ 5	\$ -	\$ 215
<b>Total</b>	<b>\$ 210</b>	<b>\$ 5</b>	<b>\$ -</b>	<b>\$ 215</b>

Net unrealized holding losses on securities available for sale, net of related tax effect, of \$16,057,000 and \$2,212,000 at September 30, 2005 and December 31, 2004, respectively, were reported in a separate component of shareholders' equity as accumulated other comprehensive loss, net of tax. The increase in net unrealized holding losses resulted from the general rise in interest rates which affected the fair market value of securities available for sale.

A summary of securities available for sale, which were in an unrealized loss position at September 30, 2005, is provided below. The Company has both the ability and intent to hold these securities for the time period necessary to recover the costs. In addition, the Company believes the decrease in value is attributable to changes in market interest rates and not credit quality of the issuer.

(Dollars in Thousands)	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
	(Unaudited)					
U.S. Treasury	\$ -	\$ -	\$ 5,433	\$ (112)	\$ 5,433	\$ (112)
U.S. Government Agency	451,718	(6,174)	324,368	(7,512)	776,086	(13,686)
Mortgage-Backed	484,911	(6,400)	199,873	(5,829)	684,784	(12,229)
States and Political Subdivisions	46,070	(343)	47,584	(822)	93,654	(1,165)
Other	910	(239)	339	(17)	1,249	(256)
<b>Total Temporarily Impaired Securities</b>	<b>\$983,609</b>	<b>\$(13,156)</b>	<b>\$577,597</b>	<b>\$(14,292)</b>	<b>\$1,561,206</b>	<b>\$(27,448)</b>

Securities available for sale and securities held to maturity with carrying values of \$1,303,614,000 and \$0, respectively, at September 30, 2005 and \$1,416,232,000 and \$210,000, respectively, at December 31, 2004 were pledged to secure public funds, trust assets on deposit and for other purposes required or permitted by law.

#### LOANS HELD FOR SALE

Loans held for sale of \$22,754,000 at September 30, 2005 decreased \$6,228,000 or 21.5% compared to the December 31, 2004 balance of \$28,982,000. The decrease in loans held for sale for the nine months ended September 30, 2005 resulted primarily from a decrease in loan volume due to rising interest rates.

#### LOANS HELD FOR INVESTMENT

The Company manages its credit risk by establishing and implementing strategies and guidelines appropriate to the characteristics of borrowers, industries, geographic locations and risk products. Diversification of risk within each of these areas is a primary objective. The objectives of the Company's policies and procedures is to ensure that loan commitments conform to current strategies and guidelines. Management continually refines the Company's credit policies and procedures to address the risks in the current and prospective environment and to reflect management's current strategic focus. The credit process is controlled with continuous credit review and analysis, and review by the internal loan review department of the Bank and external auditors and regulatory authorities. The Company's loans are widely diversified by borrower and industry group. The Company does not have any single loan relationship that it considers material to the overall portfolio.

The Company has collateral management policies in place so that collateral lending of all types is approached on a basis consistent with safe and sound standards. Valuation analysis is utilized to take into consideration the potentially adverse economic conditions under which liquidation could occur. Collateral accepted against the commercial loan portfolio includes accounts receivable and inventory, marketable securities, equipment, agricultural products and real estate. Autos, real estate, life insurance and marketable securities are accepted as collateral for the consumer loan portfolio.

Management of the Company believes that the Company has benefited from increased loan demand due to passage of the North American Free Trade Agreement ("NAFTA") and the strong population growth in the Rio Grande Valley. The effects of NAFTA have also increased cross-border trade and industrial development including activity at twin manufacturing plants located on each side of the border (referred to as maquiladoras), which benefit the Rio Grande Valley economy. Management believes that NAFTA will continue to have a positive impact on the Company's growth and earnings prospects.

The majority of the Company's loans are loans held for investment. Loans held for sale, which are mortgage loans originated and intended for sale in the secondary market, represent 0.6% of total loans at September 30, 2005.

International loans are loans to borrowers that are domiciled in a country other than the United States of America, primarily borrowers in Mexico. The Company's total international loans at September 30, 2005 of \$55,143,000 represented 1.4% of total loans held for investment.

Total loans held for investment of \$3,965,628,000 at September 30, 2005 increased \$215,109,000 or 5.7% compared to December 31, 2004 levels of \$3,750,519,000. The increase in loans held for investment resulted primarily from an increase in commercial and real estate loans combined with \$118,129,000 in loans held for investment acquired with the Mercantile acquisition during first quarter 2005.

The following table presents the composition of the loans held for investment portfolio (dollars in thousands):

	September 30, 2005	December 31, 2004
	(Unaudited)	
Commercial	\$1,120,350	\$1,098,028
Commercial Tax-Exempt	33,468	49,622
Total Commercial	1,153,818	1,147,650
Agricultural	62,472	78,761
Real Estate		
Construction	897,930	768,497
Commercial Mortgage	1,248,871	1,199,600
Agricultural Mortgage	118,569	100,628
1-4 Family Mortgage	321,932	286,809
Total Real Estate	2,587,302	2,355,534
Consumer	166,208	172,571
Total Principal Amount of Loans Held for Investment	3,969,800	3,754,516
Less: Unearned Income and Net Unamortized Deferred Fees and Costs	4,172	3,997
Total Loans Held for Investment	\$3,965,628	\$3,750,519

In the ordinary course of business, the Company's subsidiary bank makes loans to its officers and directors, including entities related to those individuals. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of collectibility or present other unfavorable features. As of September 30, 2005 and December 31, 2004, loans outstanding to directors, officers and their affiliates totaled approximately \$84,195,000 and \$65,181,000, respectively.

The Company's policy on maturity extensions and rollovers is based on management's assessment of individual loans. Approvals for the extension or renewal of loans without reduction of principal for more than one twelve-month period are generally avoided, unless the loans are fully secured and properly margined by cash or marketable securities, or are revolving lines subject to annual analysis and renewal.

#### NONPERFORMING ASSETS

The Company has several procedures in place to assist in maintaining the overall quality of its loan portfolio. The Bank has established underwriting guidelines to be followed by its officers and monitors its delinquency levels for any negative or adverse trends.

Nonperforming assets consist of nonperforming (impaired) loans and other assets, primarily real estate, acquired in partial or full satisfaction of loan obligations. The Company's policy generally is to place a loan on nonaccrual status when payment of principal or interest is contractually past due 90 days, or earlier when concern exists as to the ultimate collection of principal and interest. At the time a loan is placed on nonaccrual status, interest previously accrued but uncollected is reversed and charged against current income unless the collateral provides more than adequate margin to ensure collection of that interest. A restructured loan is generally a loan that is accruing interest, but on which concessions in terms have been made as a result of deterioration in the borrower's financial condition. The Company's classification of nonperforming loans includes those loans for which management believes collection is doubtful. Management is not aware of any specific borrower relationships that are not reported as nonperforming where management has serious doubts as to the ability of such borrowers to comply with the present loan repayment terms which would cause nonperforming assets to increase materially.

Nonperforming assets of \$49,750,000 at September 30, 2005 increased \$22,602,000 or 83.3% compared to December 31, 2004 levels of \$27,148,000. Nonaccrual loans of \$38,752,000 at September 30, 2005 increased \$19,002,000 or 96.2% compared to \$19,750,000 at December 31, 2004. The increase was primarily the result of the addition of one loan relationship totaling \$18,100,000. During second quarter 2005, the Company reduced the interest rate on a real estate loan and identified this loan as a troubled debt restructuring. The Company reported \$1,804,000 as total restructured loans at September 30, 2005. Foreclosed and other assets of \$9,194,000 at September 30, 2005 increased \$1,796,000 or 24.3% compared to \$7,398,000 at December 31, 2004. The increase was primarily the result of the addition of a property totaling \$2,900,000, partially offset by the sale of a property totaling \$850,000. Management actively seeks buyers for all Other Real Estate. See "Noninterest Expense" below.

Loans which are contractually past due 90 days or more, which are both well secured or guaranteed by financially responsible third parties and in the process of collection, generally are not placed on nonaccrual status. The amount of such loans at September 30, 2005 and December 31, 2004 totaled \$13,524,000 and \$19,684,000, respectively, reflecting a decrease of \$6,160,000 or 31.3%. The decrease at September 30, 2005 as compared to December 31, 2004 resulted primarily from one loan

relationship totaling \$7,110,000 that was either current or paid off and another loan relationship totaling \$3,235,000 which was transferred to foreclosed and other assets. The decrease was partially offset by the addition of one loan relationship totaling \$3,611,000. The ratio of nonperforming assets plus accruing loans 90 days or more past due as a percent of total loans held for investment and foreclosed and other assets at September 30, 2005 increased to 1.59% from 1.25% at December 31, 2004.

An analysis of the components of nonperforming assets follows (dollars in thousands):

	September 30, 2005	December 31, 2004
	(Unaudited)	
Nonaccrual Loans	\$38,752	\$19,750
Restructured Loans	1,804	-
Nonperforming Loans	40,556	19,750
Foreclosed and Other Assets	9,194	7,398
Total Nonperforming Assets	49,750	27,148
Accruing Loans 90 Days or More Past Due	13,524	19,684
Total Nonperforming Assets and Accruing Loans 90 Days or More Past Due	\$63,274	\$46,832
Nonperforming Loans as a Percentage of Loans Held for Investment	1.02%	0.53%
Nonperforming Assets as a Percentage of Loans Held for Investment and Foreclosed and Other Assets	1.25	0.72
Nonperforming Assets as a Percentage of Total Assets	0.79	0.46
Nonperforming Assets Plus Accruing Loans 90 Days or More Past Due as a Percentage of Loans Held for Investment and Foreclosed and Other Assets	1.59	1.25

Management regularly reviews and monitors the loan portfolio to identify borrowers experiencing financial difficulties. Management believes that, at September 30, 2005, all such loans had been identified and included in the nonaccrual, renegotiated or 90 days or more past due loan totals reflected in the table above. Management continues to emphasize maintaining a low level of nonperforming assets and returning nonperforming assets to an earning status.

#### ALLOWANCE FOR LOAN LOSSES - CRITICAL ACCOUNTING POLICY

Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses and the appropriate provision required to maintain an adequate allowance. Estimating the allowance is a critical accounting policy. It is subjective in nature and requires material estimates that may be subject to revision as facts and circumstances warrant. The Company's allowance for loan losses represents estimations based on guidance provided by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan-an amendment of FASB Statements No. 5 and 15", as amended by Statement No. 118, "Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures-an amendment of FASB Statement No. 114" and Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies".

In assessing the adequacy of the allowance, management reviews the size, quality and risks of loans in the portfolio and considers factors such as specific known risks, past experience, the status and amount of nonperforming assets and economic conditions. Specific percentages are allocated to various categories of loans based upon various factors including historical losses, while additional amounts are added for individual loans considered to have specific loss potential. Loans identified as losses are charged off. In addition, the loan review committee of the Bank reviews the assessments of management in determining the adequacy of the Bank's allowance for loan losses on a quarterly basis. Based on total allocations, the provision is recorded to maintain the allowance at a level deemed appropriate by management based on probable losses in the loan portfolio. There can be no assurance that future additions or reductions to the allowance will not be necessary.

The allowance for loan losses at September 30, 2005 totaled \$51,368,000 representing a net increase of \$6,344,000 or 14.1% compared to \$45,024,000 at December 31, 2004. The acquisition of Mercantile during first quarter 2005 attributed to \$1,524,000 of the increase. In addition, during the third quarter of 2005, the Company recorded an additional provision to the allowance for loan losses of \$2,500,000 for probable losses on loans to borrowers affected by Hurricane Rita. This additional provision resulted from the decision of management to make an addition to the allowance based upon an additional percentage of the Bank's loans to customers located in, or secured by collateral located in, the areas most severely impacted by Hurricane Rita. Management believes that the allowance for loan losses at September 30, 2005 adequately reflects the probable losses in the loan portfolio. Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments of information available to them at the time of their examination.

The following table summarizes the activity in the allowance for loan losses (dollars in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
	(Unaudited)			
Balance at Beginning of Period	\$48,022	\$41,956	\$45,024	\$31,234
Balance from Acquisition	-	-	1,524	8,795
Provision for Loan Losses	8,720	6,197	19,928	14,813
Charge-Offs				
Commercial	4,203	4,834	12,776	11,177
Agricultural	4	-	60	189
Real Estate	512	89	1,647	243
Consumer	942	669	2,377	2,018
Total Charge-Offs	5,661	5,592	16,860	13,627
Recoveries				
Commercial	108	312	865	1,023
Agricultural	-	32	27	36
Real Estate	7	24	121	167
Consumer	172	224	739	712
Total Recoveries	287	592	1,752	1,938
Net Charge-Offs	5,374	5,000	15,108	11,689
Balance at End of Period	\$51,368	\$43,153	\$51,368	\$43,153
Allowance for Loan Losses as a Percentage of				
Loans Held for Investment	1.30%	1.22%	1.30%	1.22%
Allowance for Loan Losses as a Percentage of				
Nonperforming Loans	126.66	259.80	126.66	259.80
Net Charge-Offs as a Percentage of Average				
Loans Held for Investment	0.54	0.57	0.52	0.49

#### PREMISES AND EQUIPMENT, NET

Premises and equipment, net of \$147,084,000 at September 30, 2005 increased by \$12,845,000 or 9.6% compared to December 31, 2004 levels of \$134,239,000. The increase was partially attributable to \$7,732,000 of premises and equipment acquired in the Mercantile acquisition during first quarter 2005, as well as \$1,185,000 in real estate purchased during the nine months ending September 30, 2005 in Houston and Rio Grande City, Texas for future banking locations. In addition, construction in progress increased \$3,213,000 primarily because of the construction in progress on four new banking centers. The Company incurred damage from Hurricane Rita to its banking centers and offices located in East Texas. The cost of the damage to such facilities is estimated to be \$1,000,000, substantially all of which is covered by insurance. In addition, management believes that a portion of the costs to reopen and clean the affected facilities is covered by insurance. The Company has initiated the repairs and clean up and continues to evaluate the cost to repair damages to its facilities.

#### GOODWILL

Goodwill of \$192,729,000 at September 30, 2005 increased \$18,226,000 or 10.4% compared to \$174,503,000 at December 31, 2004. The increase is primarily attributable to \$17,776,000 in goodwill added with the Mercantile acquisition. In addition, goodwill adjustments totaling \$384,000 and \$66,000 relating to the Southeast Texas and Valley Mortgage acquisitions, respectively, were recorded during the nine months ended September 30, 2005. The Company is continuing to evaluate the goodwill recorded with the Mercantile and Valley Mortgage acquisitions.

#### IDENTIFIABLE INTANGIBLES, NET

Identifiable intangibles, net of \$27,224,000 at September 30, 2005 decreased \$2,383,000 or 8.0% compared to \$29,607,000 at December 31, 2004. The decrease for the nine months ended September 30, 2005 is attributable to amortization of \$4,452,000, including amortization of \$542,000 on the unfavorable lease commitment obtained with the Southeast Texas acquisition included as a reduction of net occupancy expense. The decrease was partially offset by the \$2,028,000 core deposit intangible added with the Mercantile acquisition. The Company is continuing to evaluate the value of the core deposit intangible obtained with the Mercantile acquisition.

## DEPOSITS

Total deposits of \$5,129,474,000 at September 30, 2005 increased \$368,634,000 or 7.7% compared to December 31, 2004 levels of \$4,760,840,000. The increase in total deposits for the nine months ended September 30, 2005 is primarily attributable to \$173,444,000 added with the Mercantile acquisition, as well as growth in the volume of business conducted by the Company.

The following table presents the composition of total deposits (dollars in thousands):

	September 30, 2005	December 31, 2004
	(Unaudited)	
Demand Deposits		
Commercial and Individual	\$ 897,117	\$ 849,865
Public Funds	10,163	16,908
Total Demand Deposits	907,280	866,773
Interest-Bearing Deposits		
Savings		
Commercial and Individual	207,819	211,393
Public Funds	367	432
Money Market Checking and Savings		
Commercial and Individual	1,197,570	980,005
Public Funds	452,983	460,202
Time Deposits		
Commercial and Individual	1,893,660	1,655,042
Public Funds	469,795	586,993
Total Interest-Bearing Deposits	4,222,194	3,894,067
Total Deposits	\$5,129,474	\$4,760,840

## OTHER BORROWED MONEY

Total other borrowed money of \$499,177,000 at September 30, 2005 increased \$37,426,000 or 8.1% compared to December 31, 2004 levels of \$461,751,000.

The components of total other borrowed money are as follows (dollars in thousands):

	September 30, 2005	December 31, 2004
	(Unaudited)	
Federal Funds Purchased and Securities		
Sold Under Repurchase Agreements	\$ 81,627	\$108,891
Federal Home Loan Bank Advances	350,538	285,848
Junior Subordinated Debentures	67,012	67,012
Total Other Borrowed Money	\$499,177	\$461,751

At September 30, 2005, the Company had available lines of credit totaling \$155,000,000 with correspondent banks for short-term liquidity needs. In addition, the Company had available credit of approximately \$802,682,000 with the Federal Home Loan Bank, of which \$350,538,000 was advanced at September 30, 2005.

## SHAREHOLDERS' EQUITY

Shareholders' equity increased by \$37,463,000 or 6.3% during the nine months ended September 30, 2005 primarily due to comprehensive income of \$51,697,000 less dividends of \$16,877,000 during the period. Comprehensive income for the period included net income of \$65,542,000 and net change in unrealized gains and losses on securities available for sale, net of tax and reclassification adjustment, of \$(13,845,000).

Bank holding companies and their subsidiary banks are required to maintain capital ratios in accordance with guidelines adopted by the Federal Reserve Board ("FRB"). The guidelines are commonly known as Risk-Based Capital Guidelines.

The table below reflects various measures of regulatory capital (dollars in thousands):

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	<b>Texas Regional Bancshares, Inc.</b>					
As of September 30, 2005 (Unaudited)						
Total Capital (to Risk-Weighted Assets)	\$543,214	12.02%	\$361,460	8.00%	\$451,824	10.00%
Tier I Capital (to Risk-Weighted Assets)	491,846	10.89	180,730	4.00	271,095	6.00
Tier I Capital (to Average Assets)	491,846	8.11	242,539	4.00	303,174	5.00
As of December 31, 2004						
Total Capital (to Risk-Weighted Assets)	\$501,326	11.91%	\$336,800	8.00%	\$421,001	10.00%
Tier I Capital (to Risk-Weighted Assets)	456,302	10.84	168,400	4.00	252,600	6.00
Tier I Capital (to Average Assets)	456,302	8.32	219,331	4.00	274,163	5.00
<b>Texas State Bank</b>						
As of September 30, 2005 (Unaudited)						
Total Capital (to Risk-Weighted Assets)	\$517,723	11.47%	\$360,985	8.00%	\$451,232	10.00%
Tier I Capital (to Risk-Weighted Assets)	466,355	10.34	180,493	4.00	270,739	6.00
Tier I Capital (to Average Assets)	466,355	7.70	242,263	4.00	302,829	5.00
As of December 31, 2004						
Total Capital (to Risk-Weighted Assets)	\$475,282	11.31%	\$336,320	8.00%	\$420,399	10.00%
Tier I Capital (to Risk-Weighted Assets)	430,258	10.23	168,160	4.00	252,240	6.00
Tier I Capital (to Average Assets)	430,258	7.86	218,899	4.00	273,624	5.00

At September 30, 2005, the Company and the Bank met the criteria for classification as “well-capitalized” under the prompt corrective action rules promulgated under the Federal Deposit Insurance Act. Designation as a well-capitalized institution under these regulations does not constitute a recommendation or endorsement of the Company or the Bank by Federal bank regulators.

## RESULTS OF OPERATIONS

### NET INCOME

Net income was \$19,829,000 and earnings per diluted common share was \$0.40 for the three months ended September 30, 2005. For the three months ended September 30, 2004, net income was \$19,821,000 and earnings per diluted common share was \$0.40. Net income increased primarily due to an increase in net interest income for the three months ended September 30, 2005 compared to the same 2004 period. The increase was offset by a decrease in net realized gains on sales of securities available for sale combined with an additional provision for possible loan losses on loans to borrowers affected by Hurricane Rita. Return on assets averaged 1.26% and 1.43% while return on shareholders’ equity averaged 12.46% and 14.10% for the three months ended September 30, 2005 and 2004, respectively.

For the nine months ended September 30, 2005, net income was \$65,542,000 compared to \$55,810,000 for the same period in 2004, representing an increase of \$9,732,000 or 17.4%. Net income increased primarily due to the recognition of a full nine months of results from the Southeast Texas acquisition completed on March 12, 2004, as well as results from the Valley Mortgage and Mercantile acquisitions. Furthermore, the Company benefited from an aggregate \$6,160,000 in special distributions received during the first two quarters of 2005, as a result of the merger of PULSE EFT Association with Discover Financial Services, Inc., a business unit of Morgan Stanley. Earnings per diluted common share was \$1.31 and \$1.16 for the nine months ended September 30, 2005 and 2004, respectively. Return on assets averaged 1.43% and return on shareholders' equity averaged 14.17% for the nine months ended September 30, 2005 compared to 1.44% and 14.30%, respectively, for the same period in 2004.

### NET INTEREST INCOME

Net interest income, reported on a tax-equivalent basis, was \$60,762,000 for the three months ended September 30, 2005 compared with \$54,813,000 for the same period in 2004, an increase of \$5,949,000 or 10.9%. The net interest margin was 4.22% for the three months ended September 30, 2005 compared to 4.34% for the same period in 2004. Tax-equivalent interest income for the three months ended September 30, 2005 was \$92,850,000, an increase of \$20,301,000 or 28.0% from the three months ended September 30, 2004. This increase in tax-equivalent interest income was largely due to growth in average interest-earning assets, which rose to \$5,718,610,000 representing a \$693,725,000 or 13.8% increase compared to the same period in 2004. The increase was further affected by a 70 basis point increase in the yield on average interest-earning assets. Tax-equivalent interest income on loans held for investment increased \$16,800,000 or 28.8% to \$75,143,000 for the three months ended September 30, 2005 compared to the same period in 2004. The increase was primarily due to a \$446,825,000 or 12.8% increase in average loans

held for investment over the same period in 2004, resulting from an 8.8% internal loan growth rate for the twelve months ended September 30, 2005. The increase was further affected by a 93 basis point increase in the yield on average loans held for investment resulting primarily from an increase in the average prime rate from 4.41% during third quarter 2004 to 6.42% during third quarter 2005. Tax-equivalent interest income on securities increased to \$17,205,000, reflecting a \$3,188,000 or 22.7% increase from the prior comparable period. This increase was attributable to a \$227,972,000 increase in average securities, up 15.0% compared to the three months ended September 30, 2004. The increase was further affected by a 24 basis point increase in the yield on average securities during third quarter 2005 compared to the same period in 2004.

For the nine months ended September 30, 2005, tax-equivalent net interest income was \$178,175,000 compared with \$151,432,000 for the same period in 2004, an increase of \$26,743,000 or 17.7%. The net interest margin was 4.25% for the nine months ended September 30, 2005 compared to 4.30% for the same period in 2004. Tax-equivalent interest income for the nine months ended September 30, 2005 was \$261,400,000, an increase of \$62,500,000 or 31.4% from the nine months ended September 30, 2004. This increase in tax-equivalent interest income was largely due to growth in average interest-earning assets, which rose to \$5,599,722,000 representing an \$893,954,000 or 19.0% increase compared to the same period in 2004. The increase was further affected by a 59 basis point increase in the yield on average interest-earning assets. For the nine months ended September 30, 2005, tax-equivalent interest income on loans held for investment increased \$53,638,000 or 33.9% to \$211,940,000 compared to the same period in 2004. The increase was primarily due to a \$693,842,000 or 21.7% increase in average loans held for investment over the same period in 2004, resulting from loans obtained with the Southeast Texas acquisition on March 12, 2004 and the Mercantile acquisition on January 14, 2005, as well as an 8.8% internal loan growth rate for the twelve months ended September 30, 2005. The increase was further affected by a 67 basis point increase in the yield on average loans held for investment resulting primarily from an increase in the average prime rate from 4.14% during the nine months ended September 30, 2004 to 5.93% during the same period in 2005. Tax-equivalent interest income on securities increased to \$48,098,000, reflecting a \$8,265,000 or 20.7% increase from the prior comparable period. This increase was attributable to a \$192,584,000 increase in average securities, up 13.0% compared to the nine months ended September 30, 2004. The increase was further affected by a 25 basis point increase in the yield on average securities during the nine months ended September 30, 2005 compared to the same period in 2004.

Interest expense increased to \$32,088,000 for the three months ended September 30, 2005 compared to \$17,736,000 for the same period in 2004, representing an increase of \$14,352,000 or 80.9%. The increase was primarily due to a 99 basis point increase in the cost of funds during third quarter 2005 compared to the same period in 2004 resulting from increasing market rates. The increase was further affected by an increase in average interest-bearing liabilities of \$612,387,000 or 15.0% to \$4,683,842,000 compared to \$4,071,455,000 for third quarter 2004. Interest expense on deposits increased by \$12,093,000 or 77.3% to \$27,731,000 for third quarter 2005 compared to the comparable period in 2004. The increase reflects the effects of higher rates offered on deposits due to increases in market rates since September 30, 2004. Average interest-bearing deposits increased by \$479,184,000 or 12.7% to \$4,238,064,000 for third quarter 2005 compared with third quarter 2004. The increase in average interest-bearing deposits was primarily attributable to an internal growth rate of 10.4% for the twelve months ended September 30, 2005. Interest expense on other borrowed money increased \$2,259,000 or 107.7% to \$4,357,000 for the three months ended September 30, 2005 compared to the same period in 2004. The increase was primarily attributable to a \$133,203,000 or 42.6% increase in average other borrowed money to \$445,778,000 during the three months ended September 30, 2005 compared to \$312,575,000 during the three months ended September 30, 2004, as well as a 121 basis point increase in the cost of other borrowed money during the three months ended September 30, 2005 compared to the same period in 2004. The increase in the cost of other borrowed money during third quarter 2005 resulted from increases in interest rates since September 30, 2004. The cost of Federal Home Loan Bank advances and junior subordinated debentures for third quarter 2005 increased by 191 and 164 basis points, respectively, compared to the same period in 2004. In addition, the average balance of Federal Home Loan Bank advances increased by \$133,293,000 or 84.0% to \$291,986,000 for third quarter 2005 compared to the same 2004 period to partially fund growth in the securities portfolio.

For the nine months ended September 30, 2005, interest expense was \$83,225,000 compared to \$47,468,000 for the same period in 2004. The increase was primarily due to a 77 basis point increase in the cost of funds during the nine months ended September 30, 2005 from the comparable period in 2004 resulting from increasing market rates. Average interest-bearing liabilities increased \$749,037,000 or 19.5% to \$4,591,765,000 for the nine months ended September 30, 2005 compared to \$3,842,728,000 for the nine months ended September 30, 2004. Interest expense on deposits totaled \$72,249,000 for the nine months ended September 30, 2005, reflecting an increase of \$29,988,000 or 71.0% compared to the same prior year period. The increase in interest expense on deposits resulted primarily from a \$614,271,000 or 17.2% increase in average interest-bearing deposits combined with a 73 basis points increase in the average rate paid on interest-bearing deposits. Interest expense on other borrowed money increased to \$10,976,000 for the nine months ended September 30, 2005 compared to \$5,207,000 for the same prior year period. The increase was primarily attributable to a \$134,766,000 or 48.0% increase in average other borrowed money to \$415,773,000 during the nine months ended September 30, 2005 compared to \$281,007,000 during the nine months ended September 30, 2004 resulting primarily from a \$121,364,000 increase in the average balance of Federal Home Loan Bank advances. In addition, the cost of other borrowed money increased by 105 basis points primarily due to an increase of 176 and 130 basis points in the cost of Federal Home Loan Bank advances and junior subordinated debentures, respectively, resulting from increasing interest rates.

The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as a "volume change". It is also affected by changes in yields earned on interest-earning assets and

rates paid on interest-bearing deposits and other borrowed funds, referred to as a "rate change". The following tables present for periods indicated the total dollar amount of interest income from average interest-earning assets and the resultant yields, reported on a tax equivalent basis, and the interest expense on average interest-bearing liabilities, expressed both in dollars and rates. Average balances are derived from average daily balances and the yields and costs are established by dividing income or expense by the average balance of the asset or liability. Income and yield on interest-earning assets include amounts to convert tax-exempt income to a tax-equivalent basis, assuming a 35% effective tax rate for 2005 and 2004 (dollars in thousands):

Tax-Equivalent Basis <sup>(1)</sup>	Three Months Ended					
	September 30, 2005			September 30, 2004		
	Average Balance	Interest	Yield/ Rate <sup>(3)</sup>	Average Balance	Interest	Yield/ Rate <sup>(3)</sup>
	(Unaudited)					
<b>Assets</b>						
<b>Interest-Earning Assets</b>						
Loans Held for Sale <sup>(2)</sup>	\$ 26,060	\$ 406	6.18%	\$ 15,301	\$ 180	4.68%
Loans Held for Investment <sup>(2)</sup>						
Commercial	1,212,230	22,112	7.24	1,138,838	17,391	6.08
Real Estate	2,552,880	49,748	7.73	2,162,582	37,402	6.88
Consumer	165,069	3,283	7.89	181,934	3,550	7.76
Total Loans Held for Investment	3,930,179	75,143	7.59	3,483,354	58,343	6.66
<b>Securities</b>						
Taxable	1,582,588	14,988	3.76	1,384,945	12,252	3.52
Tax-Exempt	168,928	2,217	5.21	138,599	1,765	5.07
Total Securities	1,751,516	17,205	3.90	1,523,544	14,017	3.66
Interest-Bearing and Time Deposits	958	10	4.14	445	2	1.79
Federal Funds Sold	9,897	86	3.45	2,241	7	1.24
Total Interest-Earning Assets	5,718,610	\$92,850	6.44%	5,024,885	\$72,549	5.74%
Cash and Due from Banks	126,634			126,523		
Premises and Equipment, Net	143,910			129,560		
Other Assets, Net	321,672			292,067		
Allowance for Loan Losses	(48,998)			(43,108)		
Total Assets	\$6,261,828			\$5,529,927		
<b>Liabilities</b>						
<b>Interest-Bearing Liabilities</b>						
Savings	\$ 211,182	\$ 229	0.43%	\$ 212,401	\$ 235	0.44%
Money Market Checking and Savings	1,622,086	7,887	1.93	1,354,253	3,084	0.91
Time Deposits	2,404,796	19,615	3.24	2,192,226	12,319	2.24
Total Savings and Time Deposits	4,238,064	27,731	2.60	3,758,880	15,638	1.66
Other Borrowed Money	445,778	4,357	3.88	312,575	2,098	2.67
Total Interest-Bearing Liabilities	4,683,842	\$32,088	2.72%	4,071,455	\$17,736	1.73%
Demand Deposits	915,798			864,818		
Other Liabilities	30,734			34,473		
Total Liabilities	5,630,374			4,970,746		
Shareholders' Equity	631,454			559,181		
Total Liabilities and Shareholders' Equity	\$6,261,828			\$5,529,927		
Net Interest Income <sup>(1)</sup>		\$60,762			\$54,813	
Less: Tax-Equivalent Adjustment		1,116			992	
Net Interest Income, As Reported		\$59,646			\$53,821	
Net Interest Margin			4.22%			4.34%

<sup>(1)</sup> For analytical purposes, income from tax-exempt assets, primarily securities issued by state and local governments or authorities, is adjusted by an increment that equates tax-exempt income to income from taxable assets (assuming a 35% tax rate). Income on a tax-equivalent basis is not considered to be in accordance with generally accepted accounting principles ("GAAP").

<sup>(2)</sup> Average balances of loans include nonaccrual loans and are presented net of unearned income and unamortized deferred fees and costs.

<sup>(3)</sup> Annualized.

Tax-Equivalent Basis <sup>(1)</sup>	Nine Months Ended					
	September 30, 2005			September 30, 2004		
	Average Balance	Interest	Yield/Rate <sup>(3)</sup>	Average Balance	Interest	Yield/Rate <sup>(3)</sup>
	(Unaudited)					
<b>Assets</b>						
Interest-Earning Assets						
Loans Held for Sale <sup>(2)</sup>	\$ 22,751	\$ 1,057	6.21%	\$ 19,634	\$ 685	4.66%
Loans Held for Investment <sup>(2)</sup>						
Commercial	1,207,144	61,946	6.86	1,095,563	47,586	5.80
Real Estate	2,513,483	140,088	7.45	1,936,845	100,700	6.94
Consumer	167,871	9,906	7.89	162,248	10,016	8.25
Total Loans Held for Investment	3,888,498	211,940	7.29	3,194,656	158,302	6.62
Securities						
Taxable	1,519,905	42,198	3.71	1,356,718	34,887	3.43
Tax-Exempt	153,626	5,900	5.13	124,229	4,946	5.32
Total Securities	1,673,531	48,098	3.84	1,480,947	39,833	3.59
Interest-Bearing and Time Deposits						
Federal Funds Sold	2,869	44	2.05	6,314	45	0.95
	12,073	261	2.89	4,217	35	1.11
Total Interest-Earning Assets	5,599,722	\$261,400	6.24%	4,705,768	\$198,900	5.65%
Cash and Due from Banks	133,316			124,028		
Premises and Equipment, Net	141,242			122,554		
Other Assets, Net	319,250			248,025		
Allowance for Loan Losses	(48,683)			(40,680)		
Total Assets	\$6,144,847			\$5,159,695		
<b>Liabilities</b>						
Interest-Bearing Liabilities						
Savings	\$ 215,330	\$ 720	0.45%	\$ 196,555	\$ 530	0.36%
Money Market Checking and Savings	1,601,953	19,583	1.63	1,244,149	7,394	0.79
Time Deposits	2,358,709	51,946	2.94	2,121,017	34,337	2.16
Total Savings and Time Deposits	4,175,992	72,249	2.31	3,561,721	42,261	1.58
Other Borrowed Money	415,773	10,976	3.53	281,007	5,207	2.48
Total Interest-Bearing Liabilities	4,591,765	\$ 83,225	2.42%	3,842,728	\$ 47,468	1.65%
Demand Deposits	905,064			766,781		
Other Liabilities	29,660			28,732		
Total Liabilities	5,526,489			4,638,241		
Shareholders' Equity	618,358			521,454		
Total Liabilities and Shareholders' Equity	\$6,144,847			\$5,159,695		
Net Interest Income <sup>(1)</sup>		\$178,175		\$151,432		
Less: Tax-Equivalent Adjustment		3,036		2,774		
Net Interest Income, As Reported		\$175,139		\$148,658		
Net Interest Margin			4.25%			4.30%

<sup>(1)</sup> For analytical purposes, income from tax-exempt assets, primarily securities issued by state and local governments or authorities, is adjusted by an increment that equates tax-exempt income to income from taxable assets (assuming a 35% tax rate). Income on a tax-equivalent basis is not considered to be in accordance with GAAP.

<sup>(2)</sup> Average balances of loans include nonaccrual loans and are presented net of unearned income and unamortized deferred fees and costs.

<sup>(3)</sup> Annualized.

The Company's net interest margin was 4.22% and 4.25% for the three and nine months ended September 30, 2005, respectively. Higher rates on interest-bearing liabilities resulting from competition for deposits within the Company's market areas and the Company's mix of interest-earning assets pressured the net interest margin causing a modest 12 basis point decline compared to the third quarter of 2004 and an even smaller five basis point decline compared to the nine month period of 2004.

The following table presents the effects of changes in volume, rate and rate/volume on interest income and interest expense for major categories of interest-earning assets and interest-bearing liabilities. Nonaccrual loans are included in assets, thereby reducing yields (see "Nonperforming Assets"). The allocation of the rate/volume variance has been made pro-rata on the percentage that volume and rate variances produce in each category. An analysis of changes in net interest income follows (dollars in thousands):

Tax-Equivalent Basis <sup>(1)</sup>	Three Months Ended September 30, 2005 Compared to 2004				Nine Months Ended September 30, 2005 Compared to 2004			
	Net Change	Due to Change in Volume	Rate/ Rate	Rate/ Volume	Net Change	Due to Change in Volume	Rate/ Rate	Rate/ Volume
	(Unaudited)							
Interest Income								
Loans Held for Sale	\$ 226	\$ 127	\$ 58	\$ 41	\$ 372	\$ 108	\$ 228	\$ 36
Loans Held for Investment	16,800	7,664	8,097	1,039	53,638	34,204	15,966	3,468
Securities								
Taxable	2,736	1,786	831	119	7,311	4,161	2,812	338
Tax-Exempt	452	392	49	11	954	1,164	(170)	(40)
Interest-Bearing and Time								
Deposits	8	2	3	3	(1)	(25)	52	(28)
Federal Funds Sold	79	24	12	43	226	65	56	105
Total Interest Income	20,301	9,995	9,050	1,256	62,500	39,677	18,944	3,879
Interest Expense								
Deposits	12,093	2,042	8,915	1,136	29,988	7,243	19,399	3,346
Other Borrowed Money	2,259	903	951	405	5,769	2,490	2,216	1,063
Total Interest Expense	14,352	2,945	9,866	1,541	35,757	9,733	21,615	4,409
Net Interest Income Before								
Allocation of Rate/Volume	5,949	7,050	(816)	(285)	26,743	29,944	(2,671)	(530)
Allocation of Rate/Volume	-	305	(590)	285	-	1,257	(1,787)	530
Changes in Net Interest Income	\$ 5,949	\$ 7,355	\$ (1,406)	\$ -	\$ 26,743	\$ 31,201	\$ (4,458)	\$ -

<sup>(1)</sup> For analytical purposes, income from tax-exempt assets, primarily securities issued by state and local governments or authorities, is adjusted by an increment that equates tax-exempt income to income from taxable assets (assuming a 35% effective federal income tax rate). Income on a tax-equivalent basis is not considered to be in accordance with GAAP.

#### PROVISION FOR LOAN LOSSES

The Company recorded a provision for loan losses of \$8,720,000 for the three months ended September 30, 2005 compared to \$6,197,000 for the three months ended September 30, 2004. For the nine months ended September 30, 2005, the Company recorded a provision for loan losses of \$19,928,000 compared to \$14,813,000 for the same period in 2004. The increases in the provision for loan losses for the three and nine months ended September 30, 2005 compared to the same periods in 2004 were a result of loan growth, management's assessment of current regional economic conditions and probable losses in the portfolio. In addition, during third quarter 2005, the Company recorded an additional provision to the allowance for loan losses of \$2,500,000 for possible losses on loans to borrowers affected by Hurricane Rita. This additional provision is not allocated to any specific loan or borrower, but was determined in part based upon the total loans made to borrowers in the affected areas or secured by properties located in the affected areas. As of the date of this report, the Company continues to evaluate loans in the areas impacted by the hurricane. Consistent with the Company's loan policies, as additional information is received and evaluated, the Company will continue analyze the allowance for loan losses. While management is not presently aware of any additional loan losses, management will consider the amount of additional provision for loan losses, if any, that may be needed to properly account for additional losses, if any, sustained by the Company as a result of the hurricane and its aftermath. Net charge-offs totaled \$5,374,000 and \$15,108,000 for the three and nine months ended September 30, 2005, respectively, compared to \$5,000,000 and \$11,689,000 for the same comparable periods in 2004. Net charge-offs to average loans held for investment increased during the nine months ended September 30, 2005 to 0.52% compared to 0.49% for the same period in 2004.

Management charges provisions for loan losses to earnings to bring the total allowance for loan losses to a level deemed appropriate. Management bases its decision on many factors which include historical loan loss experience, the volume and type of lending conducted by the Company, the amount of nonperforming assets, specific provisions for individual nonperforming loans, regulatory policies, generally accepted accounting principles, and general economic conditions, particularly as they relate to the Company's lending area. For additional information on charge-offs and recoveries and the aggregate provision for loan losses, see the "Allowance for Loan Losses – Critical Accounting Policy" section of this report.

## NONINTEREST INCOME

The Company's primary sources of noninterest income are service charges on deposit accounts, other banking service related fees, data processing fees and trust fees. Noninterest income totaled \$19,848,000 for the three months ended September 30, 2005 compared to \$20,595,000 for the same period in 2004. Excluding net realized gains on sales of securities available for sale, noninterest income for third quarter 2005 increased \$1,741,000 or 9.9% compared to third quarter 2004. The increase was primarily attributable to a \$1,403,000 increase in gains on sales of loans held for sale and mortgage servicing rights. For the nine months ended September 30, 2005, noninterest income totaled \$65,612,000, up from \$52,934,000 for the same period in 2004. Excluding net realized gains on securities available for sale of \$796,000 and \$4,845,000 for the nine months ended September 30, 2005 and 2004, respectively, and the aggregate \$6,160,000 in special distributions received during the first two quarters of 2005 as a result of the merger of PULSE EFT Association with Discover Financial Services, noninterest income for the nine months ended September 30, 2005 increased \$10,567,000 or 22.0% over the same period in 2004. The majority of the increase is attributable to an increase in total service charges, trust fees and gains on sales of loans held for sale and mortgage servicing rights.

Total service charges of \$12,783,000 for the three months ended September 30, 2005 increased \$59,000 or 0.5% compared to \$12,724,000 for the same period in 2004. The increase was largely due to a \$507,000 or 23.1% increase in other service charges resulting primarily from a \$302,000 increase in merchant credit and debit card income combined with \$128,000 in mortgage banking fees generated from Valley Mortgage. The increase was substantially offset by a \$448,000 or 4.3% decrease in service charges on deposit accounts. The decrease resulted primarily from a \$347,000 reduction in non-sufficient and return item charges. Total service charges were \$37,219,000 for the nine months ended September 30, 2005 compared to \$34,496,000 for the same period in 2004, reflecting an increase of 7.9%. The increase in total service charges is reflective of the increase in average deposits, excluding time deposits of, \$514,862,000 or 23.3% for the nine months ended September 30, 2005 compared with the same period in 2004 combined with a \$1,143,000 increase in merchant debit and credit card income. The increase was further affected by an increase in automated teller machine income of \$558,000 for the nine months ended September 30, 2005 compared with the comparable prior year period and \$363,000 in mortgage banking fees generated from Valley Mortgage.

Insurance commissions, fees and premiums, net for the three months ended September 30, 2005 totaled \$997,000 decreasing by \$176,000 or 15.0% compared to \$1,173,000 for the same period in 2004. The decrease resulted primarily from \$110,000 decrease in title insurance income, net during third quarter 2005 compared to third quarter 2004. For the nine months ended September 30, 2005, insurance commissions, fees and premiums, net of \$2,974,000 increased \$428,000 or 16.8% compared to \$2,546,000 for the comparable period in 2004. The increase in insurance commissions, fees and premiums, net for the nine months ended September 30, 2005 resulted primarily from the inclusion of a full nine months of income generated by the title insurance and general lines insurance agencies acquired with the Southeast Texas acquisition. The principal component of insurance commissions, fees and premiums, net, prior to the Southeast Texas transaction, was insurance commissions and fees received from the sale of credit life insurance. Prior to the merger with Southeast Texas, the Company did not have other significant insurance business.

Trust fees of \$1,892,000 for the three months ended September 30, 2005 increased \$218,000 or 13.0% compared to \$1,674,000 for the comparable prior year period. Trust fees were \$5,636,000 for the nine months ended September 30, 2005 compared to \$3,845,000 for the same period in 2004, increasing by \$1,791,000 or 46.6%. The increase in trust fees is reflective of the increase in the average fair value of trust accounts by 48.8% from \$1,094,311,000 during the nine months ended September 30, 2004 to \$1,627,939,000 for the nine months ended September 30, 2005. The increase in the average fair value of trust accounts is primarily due to the addition of \$623,267,000 in trust assets with the Southeast Texas acquisition in March 2004 and additional trust business developed during the last twelve months. The fair market value of trust accounts at September 30, 2005 was \$1,806,229,000 compared to \$1,466,841,000 at December 31, 2004 and \$1,420,664,000 at September 30, 2004. Assets held by the trust department of the Bank in fiduciary or agency capacities are not assets of the Company and are not included in the condensed consolidated balance sheets.

Net realized gains on sales of securities available for sale for the three months ended September 30, 2005 totaled \$475,000 compared to \$2,963,000 for the same period in 2004. For the nine months ended September 30, 2005, net realized gains on sales of securities available for sale totaled \$796,000 compared to \$4,845,000 for the comparable period in 2004. During the nine months ended September 30, 2004, the Company sold various callable securities with unrealized gains before their anticipated call dates. During 2005, opportunities to recognize unrealized gains in the investment portfolio decreased as gross unrealized gains in the available for sale portfolio decreased from \$20,900,000 at December 31, 2003 to \$7,476,000 at December 31, 2004. Net unrealized holding loss on securities available for sale, net of tax, totaled \$16,057,000 at September 30, 2005. See "Shareholders' Equity".

Data processing service fees of \$2,159,000 for the three months ended September 30, 2005 increased \$79,000 or 3.8% compared to \$2,080,000 for the three months ended September 30, 2004. During the nine months ended September 30, 2005, data processing service fees increased \$601,000 or 9.5% to \$6,931,000 compared to \$6,330,000 during the same period in 2004. The increase in data processing fees for the nine months ended September 30, 2005 compared to the same period last year was due to an increase in account volume for one data processing client. In addition, during first quarter 2005, the Company collected a nonrecurring \$332,000 termination fee. There were 24 data processing clients at September 30, 2005 and 26 at September 30, 2004.

Loan servicing loss, net, which includes amortization of the mortgage servicing rights (“MSR”) asset, decreased \$325,000 to a \$352,000 net servicing loss for third quarter 2005 compared to a \$677,000 net servicing loss for third quarter 2004. During the nine months ended September 30, 2005, loan servicing loss, net decreased \$942,000 to a \$196,000 net servicing loss compared to a \$1,138,000 net servicing loss for the same period in 2004. The decreases resulted primarily from \$185,000 and \$536,000 in servicing income generated from Valley Mortgage for the three and nine months ended September 30, 2005, respectively, as well as a decrease in MSR amortization of \$172,000 and \$648,000 for the three and nine months ended September 30, 2005, respectively, compared to the comparable prior year periods. The decrease was primarily attributable to a slowdown in prepayments.

Other noninterest income of \$1,894,000 for the three months ended September 30, 2005 increased \$1,236,000 compared to \$658,000 for the comparable 2004 period. The increase resulted primarily from a \$1,403,000 increase in gains on sales of loans held for sale and mortgage servicing rights. During the nine months ended September 30, 2005, other noninterest income increased \$10,242,000 to \$12,252,000 compared to \$2,010,000 during the same period in 2004. The increase for the nine months ended September 30, 2005 compared to the same period in 2004 resulted primarily from an aggregate \$6,160,000 in special distributions received during the first two quarters of 2005, as a result of the merger of PULSE EFT with Discover Financial Services. In addition, gains on sales of loans held for sale and mortgage servicing rights increased \$3,956,000 during the nine months ending September 30, 2005, respectively, compared to the same 2004 period.

#### NONINTEREST EXPENSE

Noninterest expense of \$40,872,000 for the three months ended September 30, 2005 increased \$2,588,000 or 6.8% compared to \$38,284,000 for the same period in 2004. For the nine months ended September 30, 2005, noninterest expense totaled \$120,966,000 compared to \$103,436,000 for the same period in 2004, representing an increase of \$17,530,000 or 16.9%. The efficiency ratio was 51.42% for the three months ended September 30, 2005 compared to 51.45% for the same period in 2004. For the nine months ended September 30, 2005, the efficiency ratio improved to 50.25% compared to 51.31% for the same period in 2004. The efficiency ratio is defined as noninterest expense divided by the total of net interest income and noninterest income.

Salaries and employee benefits, the largest category of noninterest expense, of \$21,886,000 for the three months ended September 30, 2005 increased by \$1,514,000 or 7.4% compared to the same period last year of \$20,372,000. Salaries and employee benefits for the nine months ended September 30, 2005 totaled \$64,213,000, reflecting an increase of \$10,636,000 or 19.9% from the comparable prior year period. The increase resulted primarily from a \$2,263,000 and \$11,053,000 increase in salaries during three and nine months ended September 30, 2005, respectively, compared to the same 2004 periods, resulting from increases in base salaries and higher levels of staff acquired with the Valley Mortgage and Mercantile acquisitions. In addition, the increase for the nine months ended September 30, 2005 reflects a full nine months of expense for staff acquired with the Southeast Texas acquisition. The increase was partially offset by a \$1,264,000 and \$2,313,000 decrease in bonus and pension plan expense for the three and nine months ended September 30, 2005, respectively. The number of full-time equivalent employees of 1,976 at September 30, 2005 represents an increase of 3.2% from 1,914 at September 30, 2004. Salaries and employee benefits averaged 1.39% of average assets for the three months ended September 30, 2005 compared to 1.47% for the three months ended September 30, 2004. For the nine months ended September 30, 2005, salaries and employee benefits averaged 1.40% of average assets compared to 1.39% for the nine months ended September 30, 2004.

Net occupancy expense totaled \$3,749,000 for the three months ended September 30, 2005 compared to \$3,136,000 reported for third quarter 2004, increasing by \$613,000 or 19.5%. For the nine months ended September 30, 2005, net occupancy expense increased \$2,297,000 or 26.7% to \$10,905,000 compared to the same period a year ago. The increase corresponds generally with growth in business volumes during the twelve months ended September 30, 2005, including business volumes attributable to the acquisition of Mercantile and its three banking locations during January 2005 and increases from a new Weslaco banking location opened during February 2005. In addition, net occupancy expense for the nine months ended September 30, 2005 includes a full nine months of expenses associated with the 29 banking locations acquired in the Southeast Texas acquisition in March 2004. Texas State Bank operated 71 banking locations as of September 30, 2005 compared to 67 as of September 30, 2004.

Equipment expense of \$3,515,000 for the three months ended September 30, 2005 increased \$293,000 or 9.1% from \$3,222,000 reported for the same period in 2004. For the nine months ended September 30, 2005, equipment expense totaled \$10,448,000, reflecting an increase of \$1,264,000 or 13.8% compared to the same period in 2004. The increase is primarily the result of equipment expenses incurred in the acquired and new banking locations. The majority of the increase in equipment expense resulted from increases in depreciation expense on furniture, fixtures and equipment and personal property tax expense. Depreciation expense on furniture, fixtures and equipment increased \$256,000 or 16.6% and \$696,000 or 16.1% for the three and nine months ending September 30, 2005, respectively, compared to the same periods last year. The increase in depreciation expense resulted primarily from a 9.1% and 10.7% increase in the average balance of the related asset accounts for the three and nine months ended September 30, 2005, respectively, compared to the same 2004 periods. In addition, personal property tax expense increased \$80,000 and \$281,000 for the three and nine months ending September 30, 2005, respectively, compared to the same periods in 2004.

Other real estate (income) expense, net includes income from foreclosed properties, gain or loss on sale of other real estate properties and direct expenses of foreclosed real estate including property taxes, maintenance costs and write-downs. Write-

downs of other real estate are required if the fair value less estimated selling costs of an asset acquired in a loan foreclosure subsequently declines below its carrying value. Other real estate expense, net of \$305,000 for the three months ended September 30, 2005 increased \$362,000 from \$57,000 other real estate income, net for the three months ended September 30, 2004. The increase in other real estate expense, net during third quarter 2005 compared to third quarter 2004 resulted primarily from a decrease of \$241,000 in net gains recognized on the sale of other real estate properties offset by an increase in net operating losses of \$185,000 generated from foreclosed properties. During the nine months ended September 30, 2005, other real estate expense, net of \$952,000 increased \$316,000 or 49.7% compared to \$636,000 reported for the nine months ended September 30, 2004. The increase resulted primarily from a decrease of \$332,000 in net gains recognized on the sale of other real estate properties. Management is actively seeking buyers for all other real estate.

Amortization of identifiable intangibles of \$1,514,000 for the three months ended September 30, 2005 decreased \$473,000 or 23.8% compared to \$1,987,000 for the same period in 2004. The decrease resulted primarily from a \$343,000 decrease in amortization on the Southeast Texas core deposit intangible. For the nine months ended September 30, 2005, amortization of identifiable intangibles increased \$620,000 or 14.1% to \$5,007,000, compared to the same prior year period. The increase is primarily the result of a full nine months of amortization on intangibles relating to the Southeast Texas acquisition combined with \$125,000 in amortization on intangibles added with the Mercantile acquisition.

A detailed summary of Noninterest Expense follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Unaudited)			
Salaries and Wages	\$16,694	\$15,614	\$49,505	\$ 40,922
Employee Benefits	5,192	4,758	14,708	12,655
Total Salaries and Employee Benefits	21,886	20,372	64,213	53,577
Net Occupancy Expense	3,749	3,136	10,905	8,608
Equipment Expense	3,515	3,222	10,448	9,184
Other Real Estate Expense, Net				
Income	(12)	(125)	(47)	(637)
(Gain) Loss on Sale	45	(196)	137	(195)
Expenses	272	200	743	1,261
Write-Downs	-	64	119	207
Total Other Real Estate (Income ) Expense, Net	305	(57)	952	636
Amortization of Identifiable Intangibles	1,514	1,987	5,007	4,387
Other Noninterest Expense				
Advertising and Public Relations	1,299	1,341	4,219	3,908
Data Processing and Check Clearing	1,896	1,809	5,717	4,741
Director Fees	192	197	573	530
Franchise Tax	101	79	351	242
Insurance	207	205	508	463
FDIC Insurance	165	167	506	508
Legal	397	540	1,014	1,419
Professional Fees	1,215	772	3,396	2,121
Postage, Delivery and Freight	744	681	2,126	2,060
Printing, Stationery and Supplies	854	845	2,761	2,772
Telephone	412	504	1,369	1,277
Other Losses	502	499	944	1,435
Miscellaneous Expense	1,919	1,985	5,957	5,568
Total Other Noninterest Expense	9,903	9,624	29,441	27,044
Total Noninterest Expense	\$40,872	\$38,284	\$120,966	\$103,436

#### INCOME TAX EXPENSE

The Company recorded income tax expense of \$10,073,000 for the three months ended September 30, 2005 compared to \$10,114,000 for the three months ended September 30, 2004. For the nine months ended September 30, 2005, income tax expense totaled \$34,315,000, representing an increase of \$6,782,000 or 24.6% compared to the same prior year period. The increase in income tax is primarily due to an increased level of pretax income for the nine months ended September 30, 2005 compared to the same periods in 2004. The Company's effective tax rate was 34.4% for the nine months ended September 30, 2005 and 33.0% for the nine months ended September 30, 2004. The increase in the effective tax rate is primarily attributable to an increase in state income taxes, as well as a decrease in tax-exempt interest income as a percentage of income before income tax expense.

## **CAPITAL AND LIQUIDITY**

Bank holding companies are required to maintain capital ratios in accordance with guidelines adopted by the Federal Reserve Board ("FRB"). The guidelines are commonly known as Risk-Based Capital Guidelines. On September 30, 2005, the Company exceeded all applicable capital requirements, having a total risk-based capital ratio of 12.02%, a Tier I risk-based capital ratio of 10.89% and a leverage ratio of 8.11%.

Shareholders' equity increased by \$37,463,000 or 6.3% during the nine months ended September 30, 2005. The increase was primarily due to net income of \$65,542,000, offset by a net change in unrealized holding gains and losses on securities available for sale, net of tax and reclassification adjustment, of \$(13,845,000) and dividends of \$16,877,000.

Liquidity management assures that adequate funds are available to meet deposit withdrawals, loan demand and maturing liabilities. Insufficient liquidity can result in higher costs of obtaining funds, while excessive liquidity can lead to a decline in earnings due to the cost of foregoing alternative investments. The ability to renew and acquire additional deposit liabilities is a major source of liquidity. The Company's principal sources of funds are primarily within the local markets of the Bank and consist of deposits, interest and principal payments on loans and securities, sales of loans and securities and borrowings.

Cash and assets which are readily marketable, or which can be pledged, or which will mature in the near future provide asset liquidity. These include cash, federal funds sold, time deposits and U.S. Treasury, U.S. Government Agency and mortgage-backed securities. At September 30, 2005, the Company's liquidity ratio, defined as cash, U.S. Treasury, U.S. Government Agency, mortgage-backed securities, interest-bearing deposits, time deposits and federal funds sold as a percentage of deposits, increased to 33.3% compared to 31.3% at December 31, 2004.

Liability liquidity is provided by access to core funding sources, principally various customers' interest-bearing and noninterest-bearing deposit accounts in the Company's trade area. The Company does not have nor does it solicit brokered deposits. Foreign deposits represent 7.9% of deposits at September 30, 2005 compared to 8.7% of deposits at September 30, 2004. Federal funds purchased and short-term borrowings are additional sources of liquidity. At September 30, 2005, the Company had lines of credit totaling \$155,000,000 with correspondent banks for short-term liquidity needs. In addition, the Company had available credit of approximately \$802,682,000 from the Federal Home Loan Bank, of which \$350,538,000 was advanced at September 30, 2005. These sources of liquidity are short-term in nature and are used, as necessary, to fund asset growth and meet short-term liquidity needs.

The Company enters into contractual commitments to extend credit, normally with a fixed expiration date, at specified rates and for specific purposes. All of the Company's commitments are contingent upon the customer maintaining specific credit standards at the time of the loan funding. At September 30, 2005, the Company had outstanding commitments to extend credit of approximately \$770,721,000, commercial letters of credit of \$62,000, standby letters of credit of \$84,566,000 and credit card guarantees of \$1,327,000. The Company guarantees the credit card debt of certain customers to the merchant bank that issues the cards, up to the customers' credit limit. In addition, the Company had construction and real estate commitments of \$4,405,000.

During the nine months ended September 30, 2005, funds for \$512,290,000 of securities purchased and \$122,854,000 of net loan growth came from various sources, including \$273,306,000 of proceeds from security sales and maturities, a net increase in deposits of \$195,191,000, a net increase in other borrowed money of \$47,426,000 and \$112,362,000 from operating activities.

The Company is dependent on dividend and interest income from the Bank and the sale of stock for its liquidity. Applicable Federal Reserve Board regulations provide that bank holding companies are permitted by regulatory authorities to pay cash dividends on their common or preferred stock if consolidated earnings and consolidated capital are within regulatory guidelines. At September 30, 2005, an aggregate of \$66,932,000 was available for payment of dividends by the Bank to the Company under the applicable limitations and without regulatory approval.

## **EFFECTS OF INFLATION**

Financial institutions are impacted differently by inflation than are industrial companies. While industrial and manufacturing companies generally have significant investments in inventories and fixed assets, financial institutions ordinarily do not have such investments. As a result, financial institutions are generally in a better position than industrial companies to respond to inflationary trends by monitoring the spread between interest costs and interest income yields through adjustments of maturities and interest rates of assets and liabilities. In addition, inflation tends to increase demand for loans from financial institutions as industrial companies attempt to maintain a constant level of goods in inventory and assets. As consumers of goods and services, financial institutions are affected by inflation as prices increase, causing an increase in costs of salaries, employee benefits, occupancy expense and similar items.

## **POSSIBLE NEGATIVE IMPACT OF LITIGATION**

The Company is a defendant in various legal proceedings arising in connection with its ordinary course of business. In the opinion of management, the consolidated financial position and results of operations of the Company will not be materially affected by the final outcome of these legal proceedings.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risk to which the Company is exposed is interest rate risk. Interest rate risk occurs when assets and liabilities reprice at different times as interest rates change. For example, if fixed-rate loans are funded with floating-rate deposits, the spread between loan and deposit rates will decline or turn negative if rates increase. Other types of market risk, such as foreign currency exchange rate risk and commodity price risk, do not arise in the normal course of the Company's business activities. The Company's interest rate risk arises from transactions entered into for purposes other than trading. The Company does not currently engage in trading activities or use derivative instruments to control interest rate risk. Even though such activities may be permitted with the approval of the Board of Directors, the Company does not intend to engage in such activities in the immediate future.

Interest rate risk is managed within the funds management policy of the Company. The principal objectives of the funds management policy are to avoid fluctuating net interest margins and to maintain consistent growth of net interest income through periods of changing interest rates. The Board of Directors oversees implementation of strategies to control interest rate risk. The Company may take steps to alter its net sensitivity position by offering deposit and/or loan structures that tend to counter the natural rate risk profile of the Company. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. Because of the volatility of market rates and uncertainties, there can be no assurance of the effectiveness of management programs to achieve a targeted moderation of risk.

In order to measure earnings and fair value sensitivity to changing rates, the Company utilizes three different measurement tools including static gap analysis, simulation earnings, and market value sensitivity (fair value at risk). The primary analytical tool used by the Company to quantify interest rate risk is a simulation model to project changes in net interest income that result from forecast changes in interest rates. This analysis estimates a percentage of change in net interest income from the stable rate scenario under scenarios of rising and falling market interest rates over a twelve month time horizon. The prime rate serves as a "driver" and is made to rise (or fall) evenly in 100 basis point increments over the twelve month forecast interval. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet.

The following table summarizes the simulated change in net interest income over a twelve month period as of September 30, 2005 and December 31, 2004 (dollars in thousands):

Changes in Interest Rates (Basis Points)	Estimated Net Interest Income	Increase (Decrease) in Net Interest Income	
		Amount	Percent
September 30, 2005 (Unaudited)			
+100	\$248,132	\$ 4,888	2.0%
-	243,244	-	-
-100	240,049	(3,195)	(1.3)
December 31, 2004			
+100	234,971	10,599	4.7
-	224,372	-	-
-100	207,191	(17,181)	(7.7)

All the measurements of risk described above are made based upon the Company's business mix and interest rate exposures at the particular point in time. An immediate 100 basis point decline in interest rates is a hypothetical rate scenario, used to calibrate risk, and does not necessarily represent management's current view of future market developments. Because of uncertainties as to the extent of customer behavior, refinance activity, absolute and relative loan and deposit pricing levels, competitor pricing and market behavior, product volumes and mix, and other unexpected changes in economic events impacting movements and volatility in market rates, there can be no assurance that simulation results are reliable indicators of net interest income under such conditions.

### ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer along with the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 ("Exchange Act"). Based upon that evaluation, the Company's Chief Executive Officer along with the Company's Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to timely alert them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There have been no changes in the Company's internal controls or in other factors which could significantly affect these controls over financial reporting that have materially affected, or are or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

In the Company's quarterly report on Form 10-Q for the three months ended June 30, 2005, the Company disclosed the filing of a lawsuit styled Andrew W. Dunn and Kenneth D. Rogers, Plaintiffs, vs. Texas State Bank, Texas Regional Bancshares, Inc., Joe Penland, Sr., and others, as Defendants. Mr. Penland is a director of the Company and Texas State Bank. Management of the Company is not aware of any material developments in this lawsuit during the three months ended September 30, 2005.

The Company and its subsidiaries are also routinely involved in other legal proceedings concerning matters arising from the conduct of the Company's and its subsidiaries' business activities, including the prior business activities of acquired companies. In the opinion of management, pending legal proceedings will not have a material adverse effect on the Company's condensed consolidated financial position or results of operations.

### **ITEM 6. EXHIBITS**

The following exhibits are filed as a part of this Quarterly Report on Form 10-Q:

- 31.1 Certification required by Rule 13a-14(a) as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002 (of Chief Executive Officer) (filed herewith).
- 31.2 Certification required by Rule 13a-14(a) as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002 (of Chief Financial Officer) (filed herewith).
- 32.1 Certification required by Rule 13a-14(b) and 18 U.S.C. §1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

**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.

TEXAS REGIONAL BANCSHARES, INC.  
(Registrant)

..... November 8, 2005 .....

..... /s/ G. E. Roney  
Glen E. Roney  
Chairman of the Board, President  
& Chief Executive Officer

..... November 8, 2005 .....

..... /s/ John A. Martin  
John A. Martin  
Executive Vice President  
& Chief Financial Officer

**CERTIFICATION REQUIRED BY RULE 13a-14(a)  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Glen E. Roney, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Texas Regional Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

.....  
Date: November 8, 2005

.....  
/s/ G.E. Roney  
Glen E. Roney  
Chairman of the Board, President  
& Chief Executive Officer

**CERTIFICATION REQUIRED BY RULE 13a-14(a)  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, John A. Martin, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Texas Regional Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

.....Date: November 8, 2005.....

-----/s/ John A. Martin  
John A. Martin  
Executive Vice President  
& Chief Financial Officer

**CERTIFICATION REQUIRED BY RULE 13a-14(b)  
AND 18 U.S.C. §1350, AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Texas Regional Bancshares, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), we, the undersigned, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to our knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the consolidated financial condition and results of operations of the Company.

.....  
Date: November 8, 2005

.....  
/s/ G.E. Roney  
Glen E. Roney  
Chairman of the Board, President  
& Chief Executive Officer

.....  
Date: November 8, 2005

.....  
/s/ John A. Martin  
John A. Martin  
Executive Vice President  
& Chief Financial Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Texas Regional and will be retained by Texas Regional and furnished to the Securities and Exchange Commission or its staff upon request.