SECURITIES AND EXCHANGE COMMISSION

# FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **1999-07-27** | Period of Report: **1999-06-30**
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## FILER

**TEXAS REGIONAL BANCSHARES INC**

CIK:**787648**| IRS No.: **742294235** | State of Incorp.:**TX** | Fiscal Year End: **1231**
Type: **10-Q** | Act: **34** | File No.: **000-14517** | Film No.: **99670724**
SIC: **6022** State commercial banks

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 1999

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)

| | |
|---|---|
| Texas | 74-2294235 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| Post Office Box 5910<br>3900 North 10th Street, 11th Floor<br>McAllen, Texas | 78502-5910 |
| (Address of principal executive offices) | (Zip Code) |

(956) 631-5400
(Registrant's telephone number, including area code)

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

There were 14,411,583 shares of the registrant's Class A Voting Common Stock, $1.00 par value, outstanding as of July 23, 1999.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

<TABLE>
<CAPTION>

| Texas Regional Bancshares, Inc. and Subsidiaries<br>Consolidated Balance Sheets<br>(Dollars in Thousands, Except Share Data) | June 30, 1999 | December 31, 1998 |
|---|---|---|
| | (Unaudited) | |
| <S> | <C> | <C> |
| Assets | | |
| Cash and Due From Banks | $ 51,505 | $ 58,274 |
| Time Deposits | 237 | 553 |
| Federal Funds Sold | 15,280 | 32,000 |
| Total Cash and Cash Equivalents | 67,022 | 90,827 |
| Securities Available for Sale, at Fair Value | 474,407 | 455,936 |
| Securities Held to Maturity, at Amortized Cost (Fair Value of $8,456 in 1999 and $14,650 in 1998) | 8,314 | 14,331 |
| Loans, Net of Unearned Discount of $5,771 in 1999 and $4,886 in 1998 | 1,179,339 | 1,089,505 |
| Less: Allowance for Loan Losses | (14,261) | (13,236) |
| Net Loans | 1,165,078 | 1,076,269 |
| Premises and Equipment, Net | 69,588 | 69,827 |
| Accrued Interest Receivable | 19,128 | 16,416 |
| Other Real Estate | 5,872 | 5,060 |
| Goodwill and Identifiable Intangibles | 25,535 | 26,894 |
| Other Assets | 9,624 | 6,769 |
| Total Assets | $ 1,844,568 | $ 1,762,329 |
| Liabilities | | |
| Deposits | | |

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| | | |
|---|---|---|
| Demand | $ 244,960 | $ 234,655 |
| Savings | 110,645 | 107,711 |
| Money Market Checking and Savings | 296,427 | 301,238 |
| Time Deposits | 980,357 | 919,338 |
| Total Deposits | 1,632,389 | 1,562,942 |
| Federal Funds Purchased and Securities Sold Under Repurchase Agreements | 13,831 | 7,407 |
| Accounts Payable and Accrued Liabilities | 18,113 | 14,512 |
| Total Liabilities | 1,664,333 | 1,584,861 |
| Commitments and Contingencies | | |
| Shareholders' Equity | | |
| Preferred Stock; $1.00 Par Value, 10,000,000 Shares Authorized; None Issued and Outstanding | -- | -- |
| Common Stock - Class A; $1.00 Par Value, 50,000,000 Shares Authorized; Issued and Outstanding 14,411,583 Shares in 1999 and 1998 | 14,412 | 14,412 |
| Paid-In Capital | 87,586 | 87,586 |
| Retained Earnings | 85,776 | 74,861 |
| Accumulated Other Comprehensive Income (Loss) | (7,539) | 609 |
| Total Shareholders' Equity | 180,235 | 177,468 |
| Total Liabilities and Shareholders' Equity | $ 1,844,568 | $ 1,762,329 |

</TABLE>

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



<TABLE>
<CAPTION>

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

| <S> | Three Months Ended June 30, 1999 <C> | Three Months Ended June 30, 1998 <C> | Six Months Ended June 30, 1999 <C> | Six Months Ended June 30, 1998 <C> |
|---|---|---|---|---|
| | (Unaudited) | | | |
| Interest Income | | | | |
| Loans, Including Fees | $ 27,064 | $ 24,644 | $ 52,840 | $ 48,165 |
| Securities | | | | |
| Taxable | 6,689 | 6,021 | 13,076 | 12,324 |
| Tax-Exempt | 510 | 375 | 996 | 739 |
| Time Deposits | 4 | 33 | 9 | 51 |
| Federal Funds Sold | 324 | 345 | 663 | 701 |
| Total Interest Income | 34,591 | 31,418 | 67,584 | 61,980 |
| Interest Expense | | | | |
| Deposits | 14,754 | 13,954 | 29,023 | 27,893 |
| Federal Funds Purchased and Securities Sold Under Repurchase Agreements | 108 | 84 | 201 | 112 |
| Total Interest Expense | 14,862 | 14,038 | 29,224 | 28,005 |
| Net Interest Income Before Provision for Loan Losses | 19,729 | 17,380 | 38,360 | 33,975 |
| Provision for Loan Losses | 1,499 | 981 | 2,822 | 1,922 |
| Net Interest Income After Provision for Loan Losses | 18,230 | 16,399 | 35,538 | 32,053 |
| Noninterest Income | | | | |
| Service Charges on Deposit Accounts | 2,311 | 1,941 | 4,382 | 3,770 |
| Other Service Charges | 623 | 516 | 1,277 | 1,102 |
| Trust Service Fees | 495 | 430 | 976 | 877 |
| Net Realized Gains (Losses) on Sales of Securities Available for Sale | (1) | 198 | (1) | 420 |
| Data Processing Service Fees | 518 | 344 | 1,013 | 685 |
| Other Operating Income | 251 | 194 | 706 | 731 |
| Total Noninterest Income | 4,197 | 3,623 | 8,353 | 7,585 |
| Noninterest Expense | | | | |
| Salaries and Employee Benefits | 5,551 | 4,390 | 10,518 | 9,057 |
| Net Occupancy Expense | 1,008 | 842 | 1,993 | 1,620 |
| Equipment Expense | 1,228 | 1,090 | 2,451 | 2,224 |
| Other Real Estate (Income) Expense, Net | 103 | (61) | 196 | (6) |
| Amortization of Goodwill and Identifiable Intangibles | 679 | 681 | 1,359 | 1,302 |
| One Time Charge - Acquisitions | -- | 46 | -- | 728 |
| Other Noninterest Expense | 2,350 | 2,650 | 4,941 | 5,240 |

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| | | | | |
|---|---|---|---|---|
| Total Noninterest Expense | 10,919 | 9,638 | 21,458 | 20,165 |
| Income Before Income Tax Expense | 11,508 | 10,384 | 22,433 | 19,473 |
| Income Tax Expense | 4,043 | 3,624 | 7,916 | 6,870 |
| Net Income | 7,465 | 6,760 | 14,517 | 12,603 |
| Other Comprehensive Income (Loss), Net of Tax - | | | | |
| Unrealized Gains (Losses) on Securities Available for Sale | | | | |
| Unrealized Holding Gains (Losses) Arising During Period | (6,829) | 101 | (8,149) | 485 |
| Less: Reclassification Adjustment for Gains (Losses) Included in Net Income | (1) | 129 | (1) | 273 |
| Total Other Comprehensive Income (Loss) | (6,828) | (28) | (8,148) | 212 |
| Comprehensive Income | $ 637 | $ 6,732 | $ 6,369 | $ 12,815 |
| Net Income Per Common Share | | | | |
| Basic | $ 0.52 | $ 0.47 | $ 1.01 | $ 0.87 |
| Diluted | 0.51 | 0.46 | 0.99 | 0.86 |

</TABLE>

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



<TABLE>
<CAPTION>

| Texas Regional Bancshares, Inc. and Subsidiaries<br>Consolidated Statements of Changes In Shareholders' Equity<br>(Dollars in Thousands) | Common Stock - Class A | Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|
| | | | (Unaudited) | | |
| <S> | <C> | <C> | <C> | <C> | <C> |
| Six Months Ended June 30, 1999 | | | | | |
| Balance, Beginning of Period | $ 14,412 | $ 87,586 | $ 74,861 | $ 609 | $ 177,468 |
| Net Income | -- | -- | 14,517 | -- | 14,517 |
| Unrealized Losses on Securities, Net of Tax and Reclassification Adjustment | -- | -- | -- | (8,148) | (8,148) |
| Total Comprehensive Income | -- | -- | 14,517 | (8,148) | 6,369 |
| Class A Common Stock Cash Dividends | -- | -- | (3,602) | -- | (3,602) |
| Balance, End of Period | $ 14,412 | $ 87,586 | $ 85,776 | $ (7,539) | $ 180,235 |
| Disclosure of Reclassification Amount | | | | | |
| Unrealized Holding Losses During Period | | | | $ (8,149) | |
| Less Reclassification Adjustment for Losses Included in Net Income | | | | (1) | |
| Net Change in Unrealized Losses on Securities Available for Sale | | | | $ (8,148) | |
| Six Months Ended June 30, 1998 | | | | | |
| Balance, Beginning of Period | $ 14,403 | $ 87,078 | $ 59,167 | $ 907 | $ 161,555 |
| Net Income | -- | -- | 12,603 | -- | 12,603 |
| Unrealized Gains on Securities, Net of Tax and Reclassification Adjustment | -- | -- | -- | 212 | 212 |
| Total Comprehensive Income | -- | -- | 12,603 | 212 | 12,815 |
| Exercise of Stock Options, 5,661 Shares of Class A Common Stock | 6 | 88 | | | 94 |
| Tax Effect of Nonqualified Stock Options Exercised | -- | 398 | -- | -- | 398 |
| Class A Common Stock Cash Dividends | -- | -- | (3,176) | -- | (3,176) |
| Cash Dividends Paid on Fractional Shares | -- | -- | (8) | -- | (8) |
| Balance, End of Period | $ 14,409 | $ 87,564 | $ 68,586 | $ 1,119 | $ 171,678 |
| Disclosure of Reclassification Amount | | | | | |
| Unrealized Holding Gains During Period | | | | $ 485 | |
| Less Reclassification Adjustment for Gains Included in Net Income | | | | 273 | |
| Net Change in Unrealized Gains on Securities Available for Sale | | | | $ 212 | |

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</TABLE>

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



<TABLE>
<CAPTION>

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 1999 | 1998 |
| | (Unaudited) | |
| <S> | <C> | <C> |
| Cash Flows from Operating Activities | | |
| Net Income | $ 14,517 | $ 12,603 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities | | |
| Depreciation, Amortization and Accretion, Net | 4,136 | 3,112 |
| Provision for Loan Losses | 2,822 | 1,922 |
| Provision for Estimated Losses on Other Real Estate and Other Assets | 16 | 7 |
| (Gain) Loss on Sale of Securities Available for Sale | 1 | (420) |
| Loss on Sale of Other Assets | 21 | 33 |
| Gain on Sale of Other Real Estate | (172) | (233) |
| Gain on Sale of Premises and Equipment | (39) | (159) |
| Change in Assets and Liabilities, Net of Effects from Merger | | |
| Decrease in Deferred Income Tax Asset | 3,552 | -- |
| Decrease in Deferred Income Tax Liability | (4,487) | (1,533) |
| Increase in Accrued Interest Receivable and Other Assets | (4,612) | (4,339) |
| Increase in Accounts Payable and Accrued Liabilities | 923 | 188 |
| Net Cash Provided by Operating Activities | 16,678 | 11,181 |
| Cash Flows from Investing Activities | | |
| Proceeds from Sales of Securities Available for Sale | 2,206 | 118,237 |
| Proceeds from Maturing Securities Available for Sale | 100,626 | 50,149 |
| Purchases of Securities Available for Sale | (126,668) | (156,375) |
| Proceeds from Maturing Securities Held to Maturity | 6,000 | 30,981 |
| Proceeds from Sale of Loans | 690 | 2,033 |
| Purchases of Loans | (2,647) | (297) |
| Loan Originations and Advances, Net | (91,491) | (41,000) |
| Recoveries of Charged-Off Loans | 182 | 471 |
| Proceeds from Sale of Premises and Equipment | 220 | 461 |
| Purchases of Premises and Equipment | (2,879) | (14,201) |
| Proceeds from Sale of Other Real Estate | 650 | 307 |
| Proceeds from Sale of Other Assets | 359 | 426 |
| Net Cash Provided By Mergers | -- | 5,160 |
| Net Cash Used in Investing Activities | (112,752) | (3,648) |
| Cash Flows from Financing Activities | | |
| Net Increase in Demand Deposits, Savings, Money Market Checking and Savings Accounts | 8,428 | 5,926 |
| Net Increase in Time Deposits | 61,019 | 42,024 |
| Net Increase in Federal Funds Purchased and Securities Sold Under Repurchase Agreements | 6,424 | 1,776 |
| Cash Dividends Paid on Class A Common Stock | (3,602) | (3,033) |
| Cash Dividends Paid on Fractional Shares | -- | (8) |
| Tax Effect of Nonqualified Stock Options Exercised | -- | 398 |
| Proceeds from the Sale of Common Stock | -- | 94 |
| Net Cash Provided by Financing Activities | 72,269 | 47,177 |
| Increase (Decrease) in Cash and Cash Equivalents | (23,805) | 54,710 |
| Cash and Cash Equivalents at Beginning of Period | 90,827 | 81,353 |
| Cash and Cash Equivalents at End of Period | $ 67,022 | $ 136,063 |

</TABLE>



<TABLE>
<CAPTION>

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 1999 | 1998 |
| | (Unaudited) | |

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<S> <C> <C>

| | | |
|---|---|---|
| Supplemental Disclosures of Cash Flow Information | | |
| Interest Paid | $29,237 | $27,723 |
| Income Taxes Paid | 9,460 | 8,148 |
| Supplemental Schedule of Noncash Investing and Financing Activities | | |
| Foreclosure and Repossession in Partial Satisfaction of Loans Receivable | 4,006 | 2,528 |
| Financing Provided For Sales of Other Real Estate | 2,371 | 1,445 |
| Net Increase in Securities Trades not Settled | 7,500 | -- |
| Net Increase in Dividends Payable | -- | 143 |
| The Company acquired Raymondville Bancorp, Inc. and its subsidiary, Bank of Texas, on February 19, 1998. Assets acquired and liabilities assumed are as follows: | | |
| Fair Value of Assets Acquired | -- | 63,944 |
| Cash Paid | -- | 9,600 |
| Liabilities Assumed | -- | 58,512 |

</TABLE>

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



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

NOTE 1: BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all information and footnotes necessary for a complete presentation of financial position, results of operations, changes in shareholders' equity, and cash flows in conformity with generally accepted accounting principles. However, the 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 six months ended June 30, 1999 and 1998 should not be considered indicative of the results to be expected for the full year. These 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 (the "Company") Annual Report on Form 10-K for the year ended December 31, 1998.

The consolidated financial statements include the accounts of Texas Regional Bancshares, Inc. and its wholly owned subsidiaries, Texas Regional Delaware, Inc. and Texas State Bank (the "Bank"). The Company eliminates all significant intercompany transactions and balances in consolidation. The Company accounts for investments in the subsidiaries on the equity method in the Parent's financial statements.

The Financial Accounting Standards Board's Statement No. 133 ("Statement 133"), "Accounting for Derivative Instruments and for Hedging Activities," was issued in June 1998. Statement 133 requires companies to recognize all derivatives as either assets or liabilities in the statement of financial condition and measure those instruments at fair value. Statement 133 requires that changes in fair value of a derivative be recognized currently in earnings unless specific hedge accounting criteria are met. Statement 133 is effective for fiscal years beginning after June 15, 1999. The Company does not currently have derivative instruments as defined by Statement 133.

NOTE 2: IMPAIRED LOANS

The Company identifies loans to be reported as impaired when such loans 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 $6.5 million at June 30, 1999 for which there was a related allowance for loan losses of $871,000. At June 30, 1999, the Company had $59,000 in impaired loans for which there was no related allowance for loan losses. The average recorded investment in impaired loans during the six months ended June 30, 1999 was $7.3 million. Interest income on impaired loans of $45,000 was recognized for cash payments received during the six months ended June 30, 1999.

NOTE 3: COMMON STOCK

On June 8, 1999, the Board of Directors approved a cash dividend or $0.125 per share for shareholders of record on July 1, 1999 and payable on July 15, 1999.



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NOTE 4: EARNINGS PER COMMON SHARE COMPUTATIONS

The table below presents a reconciliation of basic and diluted earnings per share computations.

| (Dollars in Thousands, Except Share Data) | Three Months Ended June 30, 1999 | Three Months Ended June 30, 1998 | Six Months Ended June 30, 1999 | Six Months Ended June 30, 1998 |
|---|---|---|---|---|
| | (Unaudited) | | | |
| Net Income Available to Common Shareholders | $ 7,465 | $ 6,760 | $ 14,517 | $ 12,603 |
| Weighted Average Number of Common Shares Outstanding Used in Basic EPS Calculation | 14,411,583 | 14,408,312 | 14,411,583 | 14,405,898 |
| Add Assumed Exercise of Outstanding Stock Options as Adjustments for Dilutive Securities | 220,738 | 242,241 | 216,143 | 243,482 |
| Weighted Average Number of Common Shares Outstanding Used in Diluted EPS Calculations | 14,632,321 | 14,650,553 | 14,627,726 | 14,649,380 |
| Basic EPS | $ 0.52 | $ 0.47 | $ 1.01 | $ 0.87 |
| Diluted EPS | 0.51 | 0.46 | 0.99 | 0.86 |

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

Forward-Looking Statements. This Management's Discussion and Analysis includes forward-looking statements, such as: statements of the Company's goals, intentions and expectations; estimates of risks and of future costs and benefits; and statements of the Company's ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: future interest rates and other economic conditions; statements by suppliers of data processing equipment and services, government agencies, and other third parties as to year 2000 compliance and costs; future laws and regulations; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, the Company's past results do not necessarily indicate its future results.

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

## GENERAL

Texas Regional Bancshares, Inc. (the "Company"), a Texas business corporation incorporated in 1983 and headquartered in McAllen, Texas, is a bank holding company within the meaning of the Bank Holding Company Act of 1956. The Company is registered with the Board of Governors of the Federal Reserve System ("Federal Reserve Board"). Texas Regional Delaware, Inc., 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. The Bank has two wholly owned subsidiaries: (i) TSB Securities, Inc., incorporated in 1997 to provide full service broker-dealer services and (ii) TSB Properties, Inc., incorporated in 1998 to receive and liquidate foreclosed assets.

Texas State Bank operates twenty banking locations in the Rio Grande Valley including four banking locations in McAllen (including its main office), four banking locations in Brownsville, three banking locations in Mission, two banking locations in Weslaco, and one banking location each in Edinburg, Harlingen, Hidalgo, Penitas, Raymondville, Rio Grande City and Roma. At June 30, 1999, Texas Regional had consolidated total assets of $1.8 billion, loans (net of unearned discount) of $1.2 billion, deposits of $1.6 billion, and shareholders' equity of $180.2 million.

On February 19, 1998, the Company completed the acquisition of three bank holding companies and their three subsidiary banks (the "Mergers"). The acquisition of Brownsville Bancshares, Inc. and its subsidiary, Brownsville National Bank, included two banking locations in Brownsville, Cameron County, Texas, with assets of approximately $100.1 million, equity of $12.1 million, loans of $42.6 million, and deposits of $87.2 million. The Company achieved this acquisition by the exchange of 984,806 shares of Company stock for all of the outstanding

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shares of Brownsville Bancshares, Inc. and cancellation of outstanding stock options. Brownsville National Bank merged with and into the Bank.

The second acquisition was TB&T Bancshares, Inc. and its subsidiary, Texas Bank and Trust of Brownsville, Cameron County, Texas. Texas Bank and Trust of Brownsville had assets of approximately $44.9 million, equity of $4.1 million, loans of $21.9 million, and deposits of $40.3 million. This acquisition was achieved by exchange of 308,039 shares of Company stock for all of the outstanding shares of TB&T Bancshares, Inc., a portion of which are retained in a holdback escrow account pending resolution of certain claims. Texas Bank and Trust of Brownsville merged with and into the Bank.

The third acquisition was Raymondville Bancorp, Inc. and its subsidiary, Bank of Texas. Bank of Texas was headquartered in Raymondville, Willacy County, Texas, with one additional banking facility in Brownsville, Texas. The shareholder of Raymondville Bancorp, Inc. received cash consideration of $9.6 million in this acquisition, and the Company paid $100,000 in consideration for a covenant not to compete. The Company discharged approximately $330,000 of existing Raymondville Bancorp, Inc. indebtedness. Bank of Texas had assets of approximately $63.9 million, equity of $5.1 million, loans of $25.5 million, and deposits of $56.5 million. Bank of Texas was merged with and into the Bank.

The Company accounted for its acquisition of Brownsville Bancshares, Inc. and TB&T Bancshares, Inc. under the pooling-of-interests method of accounting, and as such, the enclosed financial information has been restated for all periods presented to include the results of operations and financial position of these acquired entities. A One Time Charge-Acquisitions of $728,000 or $0.03 per diluted common share, net of federal income tax, reduced net income for the six months ended June 30, 1998. These expenses, primarily professional fees and computer conversion costs, related to business combinations accounted for by the pooling-of-interests method. The Company accounted for its acquisition of Raymondville Bancorp, Inc. under the purchase method of accounting; therefore, the results of operations are included in the consolidated financial statements from the date of acquisition, February 19, 1998.

The Company has entered into a definitive agreement to acquire Harlingen Bancshares, Inc. and its subsidiary, Harlingen National Bank. At March 31, 1999, Harlingen Bancshares, Inc. had assets of $225.3 million, equity of $21.0 million, loans of $127.8 million, and deposits of $203.4 million. The definitive agreement calls for a cash consideration of approximately $34.0 million for all outstanding shares of Harlingen Bancshares, Inc. and is subject to approval by the appropriate regulators and satisfaction of certain other conditions. The purchase is expected to close during the third quarter of 1999 and to be accounted under the purchase method of accounting.

## FINANCIAL CONDITION

### CASH AND CASH EQUIVALENTS

The Company, through its main office and branches, 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, wire transfer, federal funds transactions, 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 $67.0 million at June 30, 1999. Comparatively, the Company had $90.8 million in cash and cash equivalents at December 31, 1998, a decrease of $23.8 million or 26.2%.

### SECURITIES

Securities consist of U.S. Treasury, federal 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 consolidated balance sheet 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 consolidated balance sheet 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 consolidated balance sheet with unrealized holding gains and losses reported in a separate component of shareholders' equity, net of applicable income taxes until realized.

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At June 30, 1999 and December 31, 1998, 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 June 30, 1999 and December 31, 1998 (dollars in thousands):

<TABLE>
<CAPTION>

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> |
| Securities Available for Sale | | | | |
| June 30, 1999 (Unaudited) | | | | |
| U.S. Government Agency .......................... | $326,172 | $ 217 | $ (8,973) | $317,416 |
| Mortgage-Backed ................................. | 115,550 | -- | (2,086) | 113,464 |
| States and Political Subdivisions .............. | 40,211 | 245 | (1,133) | 39,323 |
| Other ........................................... | 4,162 | 45 | (3) | 4,204 |
| Total ........................................ | $486,095 | $ 507 | $(12,195) | $474,407 |
| December 31, 1998 | | | | |
| U.S. Government Agency .......................... | $313,647 | $ 1,289 | $ (966) | $313,970 |
| Mortgage-Backed ................................. | 101,670 | 206 | (511) | 101,365 |
| States and Political Subdivisions .............. | 36,112 | 994 | (118) | 36,988 |
| Other ........................................... | 3,562 | 51 | -- | 3,613 |
| Total ........................................ | $454,991 | $ 2,540 | $ (1,595) | $455,936 |
| Securities Held to Maturity | | | | |
| June 30, 1999 (Unaudited) | | | | |
| U.S. Treasury .................................. | $ 5,006 | $ 63 | $ -- | $ 5,069 |
| States and Political Subdivisions .............. | 3,308 | 79 | -- | 3,387 |
| Total ........................................ | $ 8,314 | $ 142 | $ -- | $ 8,456 |
| December 31, 1998 | | | | |
| U.S. Treasury .................................. | $ 10,013 | $ 173 | $ -- | $ 10,186 |
| States and Political Subdivisions .............. | 4,318 | 146 | -- | 4,464 |
| Total ........................................ | $ 14,331 | $ 319 | $ -- | $ 14,650 |

</TABLE>

Net unrealized holding gains (losses), net of related tax effect, of ($7.5 million) and $609,000 at June 30, 1999 and December 31, 1998, respectively, on securities available for sale are reported as a separate component of shareholders' equity and as other comprehensive income.

Securities with carrying values of $428.4 million at June 30, 1999 and $351.7 million at December 31, 1998 were pledged to secure public funds, trust assets on deposit and for other purposes required or permitted by law.

LOANS

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. Policies and procedures are developed 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 by review by



internal and external auditors and regulatory authorities. The Company's loans are widely diversified by borrower and industry group.

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

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receivable and inventory, marketable securities, equipment and agricultural products. Autos, deeds of trust, life insurance and marketable securities are accepted as collateral for the installment 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. More recently, the continued devaluation of the Mexican peso relative to the U.S. dollar has reduced retail sales to residents of Mexico. However, the effects of NAFTA and the devaluation 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 the on-going Mexican financial problems will not have a material adverse effect on the Company's growth and earnings prospects, in part because the Company presently has a low percentage of loans secured by Mexican assets or that otherwise rely on collateral located in Mexico.

The extension of credits denominated in a currency other than that of the country in which a borrower is located are called "cross-border" credits. The Company has some dollar-denominated cross-border credits to individuals or companies that are residents of, or domiciled in Mexico. The Company's total cross-border credits at June 30, 1999 of $7.4 million represented 0.6% of total loans. See "Nonperforming Assets" for additional information on cross-border credits.

Total loans of $1.2 billion at June 30, 1999 increased $89.8 million or 8.2% compared to December 31, 1998 levels of $1.1 billion. The increase in total loans for the six months ended June 30, 1999 reflects growth in all loan categories except Commercial Tax-Exempt and Agricultural loans and is representative in part to the vitality of the Rio Grande Valley economy. The following table presents the composition of the loan portfolio (dollars in thousands):

| | June 30, 1999 | December 31, 1998 |
|---|---|---|
| | (Unaudited) | |
| Commercial ............................ | $ 345,962 | $ 311,966 |
| Commercial Tax-Exempt ................ | 19,943 | 22,155 |
| Total Commercial Loans ............ | 365,905 | 334,121 |
| Agricultural ......................... | 44,826 | 52,302 |
| Real Estate | | |
| Construction ....................... | 85,018 | 66,018 |
| Commercial Mortgage ............... | 383,878 | 354,134 |
| Agricultural Mortgage ............. | 36,830 | 34,440 |
| 1-4 Family Mortgage ............... | 133,024 | 128,945 |
| Total Real Estate ............... | 638,750 | 583,537 |
| Consumer ............................. | 129,858 | 119,545 |
| Total Loans ....................... | $1,179,339 | $1,089,505 |

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 nonaccrual loans, loans for which the interest rate has been renegotiated below originally contracted rates and real estate or other assets that have been 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. The Company's classification of nonperforming loans includes

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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 $12.6 million at June 30, 1999 decreased $3.1 million, 19.9% compared to December 31, 1998 levels of $15.8 million. Nonaccrual loans of $6.5 million at June 30, 1999 decreased $3.9 million or 37.5% compared to $10.4 million at December 31, 1998. The decrease in nonaccrual loans during 1999 resulted from foreclosure on several credits secured primarily by real estate. Cross-border nonaccrual loans at June 30, 1999 of $2.6 million reflect no change from December 31, 1998. The increase in foreclosed assets during 1998 was primarily attributable to a higher rate of foreclosure loans with real estate collateral, net of write-downs and liquidations. 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 past due 90 days or more at June 30, 1999 and December 31, 1998 that are not classified as nonaccrual totaled $4.2 million and $3.1 million, respectively. The increase in accruing loans past due 90 days or more at June 30, 1999 as compared to the year ended December 31, 1998 is partly attributable to several diverse loans secured primarily by real estate. The ratio of Nonperforming Assets Plus Accruing Loans 90 Days or More Past Due as a percent of Total Loans and Foreclosed Assets at June 30, 1999 decreased to 1.42% from 1.72% at December 31, 1998 due primarily to the increase in total loans.

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

| | June 30, 1999 | December 31, 1998 |
|---|---|---|
| | (Unaudited) | |
| Nonaccrual Loans | $ 6,510 | $10,414 |
| Renegotiated Loans | -- | -- |
| Nonperforming Loans | 6,510 | 10,414 |
| Foreclosed Assets | 6,129 | 5,368 |
| Total Nonperforming Assets | 12,639 | 15,782 |
| Accruing Loans 90 Days or More Past Due | 4,161 | 3,099 |
| Total Nonperforming Assets and Accruing Loans 90 Days or More Past Due | $16,800 | $18,881 |
| Nonperforming Loans as a % of Total Loans | 0.55% | 0.96% |
| Nonperforming Assets as a % of Total Loans and Foreclosed Assets | 1.07 | 1.44 |
| Nonperforming Assets as a % of Total Assets | 0.69 | 0.90 |
| Nonperforming Assets Plus Accruing Loans 90 Days or More Past Due as a % of Total Loans and Foreclosed Assets | 1.42 | 1.72 |



Management regularly reviews and monitors the loan portfolio to identify borrowers experiencing financial difficulties. Management believes that, at June 30, 1999, 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

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. 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. A specific percentage is allocated to total loans in good standing and not specifically reserved 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. Based on total allocations, the provision is recorded to maintain the allowance at a level deemed appropriate by management. While management uses available information to recognize losses on loans, there can be no assurance that future additions to

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the allowance will not be necessary.

The allowance for loan losses at June 30, 1999 totaled $14.3 million, representing a net increase of $1.0 million or 7.7% compared to $13.2 million at December 31, 1998. Management believes that the allowance for loan losses at June 30, 1999 adequately reflects the risks in the loan portfolio. Various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company 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):

<TABLE>
<CAPTION>

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 1999 | 1998 | 1999 | 1998 |
| | (Unaudited) | | | |
| <S> | <C> | <C> | <C> | <C> |
| Balance at Beginning of Period ........................ | $13,673 | $12,115 | $13,236 | $11,291 |
| Balance from Acquisitions ............................. | -- | -- | -- | 308 |
| Provision for Loan Losses ............................. | 1,499 | 981 | 2,822 | 1,922 |
| Charge-Offs | | | | |
| Commercial ........................................ | 674 | 300 | 1,287 | 528 |
| Agricultural ...................................... | -- | 630 | 5 | 643 |
| Real Estate ....................................... | 28 | 111 | 48 | 231 |
| Consumer .......................................... | 281 | 319 | 639 | 552 |
| Total Charge-Offs ................................ | 983 | 1,360 | 1,979 | 1,954 |
| Recoveries | | | | |
| Commercial ........................................ | 22 | 47 | 63 | 171 |
| Agricultural ...................................... | 2 | -- | 5 | -- |
| Real Estate ....................................... | 2 | 195 | 12 | 197 |
| Consumer .......................................... | 46 | 60 | 102 | 103 |
| Total Recoveries ................................. | 72 | 302 | 182 | 471 |
| Net Charge-Offs ....................................... | 911 | 1,058 | 1,797 | 1,483 |
| Balance at End of Period .............................. | $14,261 | $12,038 | $14,261 | $12,038 |
| Ratio of Allowance for Loan Losses to Loans Outstanding, Net of Unearned Discount ......... | 1.21% | 1.19% | 1.21% | 1.19% |
| Ratio of Allowance for Loan Losses to Nonperforming Loans ................................ | 219.06 | 143.43 | 219.06 | 143.43 |
| Ratio of Net Charge-Offs to Average Total Loans Outstanding, Net of Unearned Discount ......... | 0.31 | 0.42 | 0.32 | 0.30 |

</TABLE>



PREMISES AND EQUIPMENT, NET

Premises and equipment of $69.6 million at June 30, 1999 decreased $239,000 or 0.3% compared to $69.8 million at December 31, 1998. The decrease for the six months ended June 30, 1999 resulted primarily from depreciation and amortization, net of additions.

GOODWILL AND IDENTIFIABLE INTANGIBLES

Goodwill and identifiable intangibles of $25.5 million at June 30, 1999 decreased $1.4 million or 5.1% compared to $26.9 million at December 31, 1998. The net decrease for the six months ended June 30, 1999 is attributable to amortization of existing intangible assets.

DEPOSITS

Total deposits of $1.6 billion at June 30, 1999 increased $69.4 million or 4.4% compared to December 31, 1998 levels of $1.6 billion. The increase in total deposits for the six months ended June 30, 1999 is primarily attributable to growth in the volume of business conducted by the Company and the vitality of the Rio Grande Valley economy. The following table presents the composition of total deposits (dollars in thousands):

| | June 30, 1999 | December 31, 1998 |
|---|---|---|

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(Unaudited)

| | | |
|---|---|---|
| Demand Deposits | | |
| Commercial and Individual | $ 238,444 | $ 227,220 |
| Public Funds | 6,516 | 7,435 |
| Total Demand Deposits | 244,960 | 234,655 |
| Interest-Bearing Deposits | | |
| Savings | | |
| Commercial and Individual | 109,492 | 106,446 |
| Public Funds | 1,153 | 1,265 |
| Money Market Checking and Savings | | |
| Commercial and Individual | 249,640 | 236,157 |
| Public Funds | 46,787 | 65,081 |
| Time Deposits | | |
| Commercial and Individual | 710,162 | 727,205 |
| Public Funds | 270,195 | 192,133 |
| Total Interest-Bearing Deposits | 1,387,429 | 1,328,287 |
| Total Deposits | $1,632,389 | $1,562,942 |

SHAREHOLDERS' EQUITY

Shareholders' equity increased by $2.8 million, or 1.6%, during the six months ended June 30, 1999 due to comprehensive income of $6.4 million less cash dividends of $3.6 million. Comprehensive income for the period included net income of $14.5 million and unrealized loss on securities available for sale, net of tax, of $8.1 million.

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



<TABLE>
<CAPTION>

| | June 30, 1999 | | December 31, 1998 | |
|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio |
| | (Unaudited) | | | |
| <S> | <C> | | <C> | |
| Total Shareholders' Equity before unrealized gains or losses on Securities Available for Sale | $187,774 | | $176,859 | |
| Less Goodwill and Other Deductions | (25,535) | | (26,894) | |
| Total Tier I Capital | 162,239 | | 149,965 | |
| Total Tier II Capital | 14,261 | | 13,236 | |
| Total Qualifying Capital | $176,500 | | $163,201 | |
| Total Risk-Based Capital | $176,500 | 13.79% | $163,201 | 14.06% |
| Total Risk-Based Capital Minimum | 102,419 | 8.00 | 92,884 | 8.00 |
| Tier I Risk-Based Capital | 162,239 | 12.67 | 149,965 | 12.92 |
| Tier I Risk-Based Capital Minimum | 51,209 | 4.00 | 46,442 | 4.00 |
| Tier I Leverage Capital | 162,239 | 8.93 | 149,965 | 8.85 |
| Tier I Leverage Capital Minimum | 72,644 | 4.00 | 67,772 | 4.00 |

</TABLE>

At June 30, 1999, the Company and the Bank met the criteria for classification as a "well-capitalized" institution 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 available for common shareholders was $7.5 million and $6.8 million and earnings per diluted common share were $0.51 and $0.46 for the three months ended June 30, 1999 and 1998, respectively. The Company incurred a One

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Time Charge-Acquisitions of $46,000 or $0.01 per diluted common share, net of federal income tax, during the quarter ended June 30, 1998. These expenses, primarily professional fees and computer conversion costs, related to business combinations accounted for by the pooling-of-interests method. Net income increased due to sustained loan growth, strong asset quality and strict expense control. Return on assets averaged 1.63% and 1.67%, respectively, while return on shareholders' equity averaged 16.27% and 15.98%, respectively, for the three months ended June 30, 1999 and 1998.

For the six months ended June 30, 1999, net income available for common shareholders was $14.5 million compared to $12.6 million for the same period in 1998, representing an increase of $1.9 million or 15.2%. Earnings per diluted common share were $0.99 and $0.86, respectively, for the six months ended June 30, 1999 and 1998. The Company incurred a One Time Charge-Acquisitions of $728,000 or $0.03 per diluted common share, net of federal income tax, during the six months ended June 30, 1998. Return on assets averaged 1.62% and return on shareholders' equity averaged 16.08% for the six months ended June 30, 1999 compared to 1.58% and 15.19%, respectively, for the same period in 1998.

INTEREST INCOME

Interest income for the three months ended June 30, 1999 was $34.6 million, an increase of $3.2 million or 10.1% from the three months ended June 30, 1998. For the six months ended June 30, 1999, interest income was $67.6 million, a $5.6 million or 9.0% increase from the same period in 1998. This increase in interest income is due to a $222.4 million or 15.3% increase in average earning assets to $1.7 billion for the three months ended June 30, 1999 from the same period last year. Average earning assets increased by $199.1 million or 13.8% to $1.6 billion for the six months ended June 30, 1999.

Interest income on loans increased $2.4 million to $27.1 million for the three months ended June 30, 1999. A $143,000 increase in average loans outstanding over the same period in 1998 propelled this increase. Interest income on securities increased to $7.2 million, a $803,000 increase from the prior comparable period. This increase was attributable to a $79.1 million increase in average securities, up 19.6% when compared to the three months ended June 30, 1998.



For the six months ended June 30, 1999, interest income on loans increased 9.7% to $52.8 million, up from $48.2 million for the same period in 1998. Interest income on securities increased to $14.1 million, an increase of $1.0 million or 7.7% from the prior period. These gains were principally related to an increase of average earning assets to $1.6 billion for the six months ended June 30, 1999, an increase of 13.8% for the same period last year.

INTEREST EXPENSE

Interest expense on deposits and other borrowings was $14.9 million for the three months ended June 30, 1999 compared to $14.0 million for the same period in 1998. For the six months ended June 30, 1999, interest expense on deposits and other borrowings was $29.2 million compared to $28.0 million for the same period in 1998. The increase in interest expense was attributable to a $205.6 million and $188.3 million increase in average interest-bearing liabilities from the three and six month comparable period, respectively.

NET INTEREST INCOME

Net interest income, reported on a tax equivalent basis, was $20.1 million for the three months ended June 30, 1999, compared with $17.8 million for the same period in 1998, an increase of 13.2%. For the six months ended June 30, 1999, net interest income increased 12.7% from the same period in 1998 to $39.1 million. The increase in net interest income during the three and six months ended June 30, 1999 was largely due to growth in average interest-earning assets, primarily loans.

The net interest margin was 4.81% for the three months ended June 30, 1999, compared with 4.90% for the same period in 1998. This nominal decrease was attributable to a forty basis point decrease in the yield on average interest earning assets to 8.37%, down from 8.77% for the same period last year. The cost of interest-bearing liabilities also decreased thirty eight basis points to 4.26% for the three months ended June 30, 1999. The net interest margin was 4.81% for the six months ended June 30, 1999, down from 4.85% for the same period in 1998. This decrease was attributable to a thirty seven basis point decrease in the yield on average interest earning assets of 8.40%, down from 8.77% for the same period last year. The cost of interest-bearing liabilities also decreased forty basis points to 4.29% for the six months ended June 30, 1999.

The following table presents for periods indicated the total dollar amount

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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 taxable-equivalent basis, assuming a 35% effective tax rate for 1999 and 1998 (dollars in thousands):



<TABLE>
<CAPTION>

| | Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 1999 | | | June 30, 1998 | | |
| Taxable-Equivalent Basis (1) | Average Balance | Interest | Yield/ Rate (2) | Average Balance | Interest | Yield/ Rate (2) |
| | | | (Unaudited) | | | |
| <S> | <C> | <C> | <C> | <C> | <C> | <C> |
| Assets | | | | | | |
| Interest-Earning Assets | | | | | | |
| Loans | | | | | | |
| Commercial........................ | $ 418,128 | $ 9,221 | 8.85% | $ 356,459 | $ 8,413 | 9.47% |
| Real Estate....................... | 619,561 | 14,587 | 9.44 | 554,606 | 13,592 | 9.83 |
| Consumer.......................... | 127,597 | 3,375 | 10.61 | 111,476 | 2,807 | 10.10 |
| Total Loans..................... | 1,165,286 | 27,183 | 9.36 | 1,022,541 | 24,812 | 9.73 |
| Securities | | | | | | |
| Taxable........................... | 440,068 | 6,689 | 6.10 | 376,057 | 6,021 | 6.42 |
| Tax-Exempt........................ | 43,556 | 765 | 7.04 | 28,420 | 581 | 8.20 |
| Total Securities................ | 483,624 | 7,454 | 6.18 | 404,477 | 6,602 | 6.55 |
| Time Deposits....................... | 355 | 4 | 4.52 | 1,852 | 33 | 7.15 |
| Federal Funds Sold.................. | 27,245 | 324 | 4.77 | 25,197 | 345 | 5.49 |
| Total Interest-Earning Assets...... | 1,676,510 | 34,965 | 8.37% | 1,454,067 | 31,792 | 8.77% |
| Cash and Due from Banks............... | 54,891 | | | 58,515 | | |
| Premises and Equipment, Net........... | 69,613 | | | 64,253 | | |
| Other Assets.......................... | 51,504 | | | 58,283 | | |
| Allowance for Loan Losses............. | (14,193) | | | (12,527) | | |
| Total Assets........................ | $ 1,838,325 | | | $ 1,622,591 | | |
| Liabilities | | | | | | |
| Interest-Bearing Liabilities | | | | | | |
| Savings............................. | $ 111,935 | $ 622 | 2.23% | $ 106,929 | $ 776 | 2.91% |
| Money Market Checking And Savings....................... | 297,491 | 2,078 | 2.80 | 256,978 | 1,851 | 2.89 |
| Time Deposits....................... | 981,061 | 12,054 | 4.93 | 842,550 | 11,327 | 5.39 |
| Total Savings and Time Deposits................... | 1,390,487 | 14,754 | 4.26 | 1,206,457 | 13,954 | 4.64 |
| Federal Funds Purchased and Securities Sold Under Repurchase Agreements........................ | 10,345 | 108 | 4.19 | 6,515 | 84 | 5.17 |
| Total Interest-Bearing Liabilities..................... | 1,400,832 | 14,862 | 4.26% | 1,212,972 | 14,038 | 4.64% |
| Demand Deposits....................... | 246,995 | | | 225,449 | | |
| Other Liabilities..................... | 6,451 | | | 14,503 | | |
| Total Liabilities................... | 1,654,278 | | | 1,452,924 | | |
| Shareholders' Equity.................. | 184,047 | | | 169,667 | | |
| Total Liabilities and Shareholders' Equity.............. | $ 1,838,325 | | | $ 1,622,591 | | |
| Net Interest Income...................... | | $ 20,103 | | | $ 17,754 | |
| Net Yield on Total Interest Earning Assets........................ | | | 4.81% | | | 4.90% |

</TABLE>

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(1) 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 interest from taxable assets (assuming a 35% tax rate).

(2) Annualized.



<TABLE>
<CAPTION>

| Taxable-Equivalent Basis (1) | Six Months Ended June 30, 1999 Average Balance | Interest | Yield/ Rate (2) | June 30, 1998 Average Balance | Interest | Yield/ Rate (2) |
|---|---|---|---|---|---|---|
| | | | (Unaudited) | | | |
| <S> | <C> | <C> | <C> | <C> | <C> | <C> |
| Assets | | | | | | |
| Interest-Earning Assets | | | | | | |
| Loans | | | | | | |
| Commercial ........................ | $ 409,255 | $ 18,129 | 8.93% | $ 349,469 | $ 16,423 | 9.48% |
| Real Estate ...................... | 605,956 | 28,444 | 9.47 | 546,907 | 26,738 | 9.86 |
| Consumer ......................... | 125,060 | 6,510 | 10.50 | 106,040 | 5,344 | 10.16 |
| Total Loans ................... | 1,140,271 | 53,083 | 9.39 | 1,002,416 | 48,505 | 9.76 |
| Securities | | | | | | |
| Taxable .......................... | 429,148 | 13,076 | 6.14 | 384,268 | 12,324 | 6.47 |
| Tax-Exempt ....................... | 43,055 | 1,496 | 7.01 | 28,045 | 1,126 | 8.10 |
| Total Securities .............. | 472,203 | 14,572 | 6.22 | 412,313 | 13,450 | 6.58 |
| Time Deposits ...................... | 357 | 9 | 5.08 | 1,676 | 51 | 6.14 |
| Federal Funds Sold ................. | 27,989 | 663 | 4.78 | 25,308 | 701 | 5.59 |
| Total Interest-Earning Assets .... | 1,640,820 | 68,327 | 8.40% | 1,441,713 | 62,707 | 8.77% |
| Cash and Due from Banks ............. | 56,727 | | | 58,336 | | |
| Premises and Equipment, Net .......... | 69,714 | | | 60,763 | | |
| Other Assets ......................... | 54,705 | | | 55,304 | | |
| Allowance for Loan Losses ............ | (13,821) | | | (12,153) | | |
| Total Assets ...................... | $ 1,808,145 | | | $ 1,603,963 | | |
| Liabilities | | | | | | |
| Interest-Bearing Liabilities | | | | | | |
| Savings ............................ | $ 110,657 | 1,233 | 2.25% | $ 105,684 | $ 1,543 | 2.94% |
| Money Market Checking and Savings ...................... | 298,852 | 4,218 | 2.85 | 254,930 | 3,695 | 2.92 |
| Time Deposits ...................... | 954,227 | 23,572 | 4.98 | 840,486 | 22,655 | 5.44 |
| Total Savings and Time Deposits .................. | 1,363,736 | 29,023 | 4.29 | 1,201,100 | 27,893 | 4.68 |
| Federal Funds Purchased and Securities Sold Under Repurchase Agreements ....................... | 9,346 | 201 | 4.34 | 4,272 | 112 | 5.29 |
| Total Interest-Bearing Liabilities .................... | 1,373,082 | 29,224 | 4.29% | 1,205,372 | 28,005 | 4.69% |
| Demand Deposits ...................... | 242,421 | | | 216,733 | | |
| Other Liabilities .................... | 10,579 | | | 14,544 | | |
| Total Liabilities .................. | 1,626,082 | | | 1,436,649 | | |
| Shareholders' Equity ................. | 182,063 | | | 167,314 | | |
| Total Liabilities and Shareholders' Equity ............ | $ 1,808,145 | | | $ 1,603,963 | | |
| Net Interest Income ..................... | | $ 39,103 | | | $ 34,702 | |
| Net Yield on Total Interest Earning Assets ....................... | | | 4.81% | | | 4.85% |

</TABLE>

(1) For analytical purposes, income from tax-exempt assets, primarily

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securities issued by state and local governments or authorities, is adjusted by an increment that equates tax-exempt income to interest from taxable assets (assuming a 35% tax rate).

(2) Annualized.



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):

| | Three Months Ended June 30, 1999 Compared To 1998 | | | | Six Months Ended June 30, 1999 Compared to 1998 | | | |
|---|---|---|---|---|---|---|---|---|
| | | Due to Change in | | | | Due to Change in | | |
| Taxable-Equivalent Basis (1) | Net Change | Volume | Rate | Rate/ Volume | Net Change | Volume | Rate | Rate/ Volume |
| | (Unaudited) | | | | | | | |
| Interest Income | | | | | | | | |
| Loans | $ 2,371 | $ 3,464 | $ (959) | $ (134) | $ 4,578 | $ 6,671 | $(1,840) | $ (253) |
| Securities | | | | | | | | |
| Taxable | 668 | 1,025 | (305) | (52) | 752 | 1,439 | (615) | (72) |
| Tax-Exempt | 184 | 309 | (82) | (43) | 370 | 603 | (152) | (81) |
| Time Deposits in Bank | (29) | (27) | (12) | 10 | (42) | (40) | (9) | 7 |
| Federal Funds Sold | (21) | 28 | (45) | (4) | (38) | 74 | (101) | (11) |
| Total Interest Income | 3,173 | 4,799 | (1,403) | (223) | 5,620 | 8,747 | (2,717) | (410) |
| Interest Expense | | | | | | | | |
| Deposits | 800 | 2,129 | (1,153) | (176) | 1,130 | 3,777 | (2,331) | (316) |
| Federal Funds Purchased and Securities Sold Under Repurchase Agreements | 24 | 49 | (16) | (9) | 89 | 133 | (20) | (24) |
| Total Interest Expense | 824 | 2,178 | (1,169) | (185) | 1,219 | 3,910 | (2,351) | (340) |
| Net Interest Income Before Allocation of Rate/Volume | 2,349 | 2,621 | (234) | (38) | 4,401 | 4,837 | (366) | (70) |
| Allocation of Rate/Volume | -- | (293) | 255 | 38 | -- | (525) | 455 | 70 |
| Changes in Net Interest Income | $ 2,349 | $ 2,328 | $ 21 | $ -- | $ 4,401 | $ 4,312 | $ 89 | $ -- |

(1) 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 interest from taxable assets (assuming a 35% effective federal income tax rate for 1999 and 1998).

PROVISION FOR LOAN LOSSES

The Company recorded a provision for loan losses of $1.5 million for the three months ended June 30, 1999, compared to $981,000 in the three months ended June 30, 1998. For the six months ended June 30, 1999, the Company recorded a provision for loan losses of $2.8 million compared to $1.9 million for the same period in 1998. The provision for loan losses reflected an increase of $518,000 or 52.8% for the three months ended June 30, 1999 and an increase of $900,000 or 46.8% for the six months ended June 30, 1999 necessary to maintain the total allowance for loan losses at an adequate level consistent with the Company's methodology. Net charge-offs totaled $911,000 and $1.1 million, respectively, for the three months ended June 30, 1999 and 1998 and decreased to .31% of average loans in 1999 compared to .42% of average loans for 1998. During the six months ended June 30, 1999 and 1998, net charge-offs totaled $1.8 million and $1.5 million, respectively, and increased to .32% of average loans in 1999 compared to .30% of average loans for 1998.

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 experience, the volume and type of lending conducted by the Company, the amount of nonperforming assets, regulatory policies, generally accepted accounting principles, and general economic conditions, particularly as they relate to the Company's lending area.

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See "Allowance for Loan Losses."

NONINTEREST INCOME

Noninterest Income totaled $4.2 million for the three months ended June 30, 1999 compared to $3.6 million for 1998. Excluding Net Realized Gains (Losses) on Sales of Securities Available for Sale, Noninterest Income increased $773,000 or 22.6% from 1998. For the six months ended June 30, 1999, Noninterest income totaled $8.4 million, up from $7.6 million for the same period in 1998. Noninterest income for the six months ended



June 30, 1999, excluding Net Realized Gains (Losses) on Sales of Securities Available for Sale increased $1.2 million or 16.6% over the same period in 1998.

Total Service Charges of $2.9 million for the three months ended June 30, 1999 increased $477,000 or 19.4% compared to $2.5 million for same period in 1998. Total Service Charges were $5.7 million for the six months ended June 30, 1999 compared to $4.9 million for the same period in 1998. The increase in Total Service Charges is attributable to increased account transaction fees generated by deposit growth experienced by the Company.

Trust Service Fees of $495,000 for the three months ended June 30, 1999 increased $65,000 or 15.1% compared to $430,000 for comparable prior year period. Trust Service Fees were $976,000 for the six months ended June 30, 1999 compared to $877,000 for the same period in 1998. The increase in Trust Service Fees is attributable to an increase in the number of trust accounts managed. The fair market value of assets managed at June 30, 1999 of $338.4 million compared to $328.9 million at the end of the first quarter and $235.2 million a year ago. 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 consolidated balance sheets.

Net Realized Gains (Losses) on Sales of Securities Available for Sale totaled $1,000 net losses for the three months ended June 30, 1999 decreased $199,000 or 100.5% compared to $198,000 net gains for 1998. Net Realized Gains (Losses) on Sales of Securities Available for Sale were $1,000 net losses for the six months ended June 30, 1999, down from $420,000 net gains during the same period in 1998. Market opportunities to realize bond profits were limited as bond prices generally fell during the first half of 1999. Unrealized holding losses on securities available for sale totaled $7.5 million during the six months ended June 30, 1999 (see "Shareholders' Equity").

Data Processing Fees of $518,000 for the three months ended June 30, 1999 increased $174,000 or 50.6% compared to $344,000 for the same period last year. During the six months ended June 30, 1999, data processing fees increased $328,000 or 47.9% to $1.0 million compared to $685,000 during the same period in 1998. This increase arose from the acquisition of additional banking clients and increased utilization of services offered to existing clients during 1998. The Company obtained three additional banking clients during the past year.

Other Operating Income of $251,000 for the three months ended June 30, 1999 increased $57,000 or 29.4% compared to $194,000 for the same 1998 period. Other Operating Income was $706,000 for the six months ended June 30, 1999 compared to $731,000 during the same quarter in 1998, a decrease of $25,000 or 3.4%. Other Operating Income included a gain on sale of bank real estate of $158,000 for the three- and six-months ended June 30, 1998.

NONINTEREST EXPENSE

Noninterest Expense of $10.9 million for the three months ended June 30, 1999 increased $1.3 million or 13.3% compared to $9.6 million for 1998. For the six months ended June 30, 1999, noninterest expense totaled $21.5 million, an increase of $1.3 million or 6.4%, from $20.2 million for the same period in 1998. The efficiency ratio of expense to total revenue improved to 44.51% for the three months ended June 30, 1999 compared to 45.80% for the same period in 1998. For the six months ended June 30, 1999, the efficiency ratio improved to 44.80% from 48.18% for 1998. The efficiency ratio is defined as Noninterest Expense (excluding other real estate income and expense) divided by the total of taxable-equivalent Net Interest Income and Noninterest Income (excluding any gains and losses on sale of securities). Excluding One Time Charge - Acquisitions of $728,000 in 1998, Noninterest Expense increased $2.0 million or 10.4% over the same six-month period in 1998. The increase results primarily from higher personnel costs and occupancy expenses associated with the new corporate headquarters building in McAllen, Texas opened in mid-1998.

Salaries and Employee Benefits, the largest category of Noninterest Expense, of $5.6 million for the three months ended June 30, 1999 increased $1.2 million or 26.4% compared to the same period last year of $4.4 million. Salary and Employee Benefits for the six months ended June 30, 1999 was $10.5 million, an increase of $1.5 million or 16.1% from the same period in 1998. The number of

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full-time equivalent employees of 770 at June 30, 1999 increased 6.2% from 725 at June 30, 1998. Salaries and Employee Benefits averaged 1.21% of average assets for the three months ended June 30, 1999 compared to 1.08% for the three months ended June 30, 1998. For the six months ended June 30, 1999, Salaries and Employee Benefits averaged 1.16% of average assets compared to 1.13% for the same period in 1998.

Net Occupancy Expense of $1.0 million for the three months ended June 30, 1999 increased $166,000 or 19.7% compared to $842,000 for 1998. For the six months ended June 30, 1999, Net Occupancy Expense increased $373,000 or 23.0% from the same period a year ago to $2.0 million. Expenses associated with the new



corporate headquarters building in McAllen, Texas, opened mid-1998, contributed to the increase in Net Occupancy Expense during the three and six months ended June 30, 1999.

Equipment Expense of $1.2 million for the three months ended June 30, 1999 increased $138,000 or 12.7% compared to $1.1 million for 1998. During the six months ended June 30, 1999, Equipment Expense totaled $2.5 million, an increase of $227,000 or 10.2% over the same period in 1998. Expenses associated with the new corporate headquarters building contributed to the increase in Equipment Expense for the three and six months ended June 30, 1999.

Other Real Estate (Income) Expense, Net, includes rent 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 of an asset acquired in a loan foreclosure subsequently declines below its carrying value. Other Real Estate (Income) Expense, Net of $103,000 expense for the three months ended June 30, 1999 decreased $164,000 or 268.9% compared to $61,000 income for the three months ended June 30, 1998. Other Real Estate (Income) Expense, Net decreased $202,000 or 3,366.7% to $196,000 expense for the six months ended June 30, 1999 compared to the same period in 1998. The net decrease for the first half of 1999 is primarily attributable to higher volumes in Other Real Estate owned and increased direct expenses of foreclosed real estate offsetting increased operating income. Management is actively seeking buyers for all Other Real Estate.

Amortization of Goodwill and Identifiable Intangibles of $679,000 or the three months ended June 30, 1999 decreased $2,000 or 0.3% compared to $681,000 for 1998. For the six months ended June 30, 1999, Amortization of Goodwill and Identifiable Intangibles totaled $1.4 million, an increase of $57,000 or 4.4% from the same period in 1998. The increase in Amortization of Goodwill and Identifiable Intangibles was due to the amortization of goodwill and core deposit premiums associated with the 1998 acquisitions.

One Time Charge - Acquisitions of $46,000 and $728,000 for the three and six months ended June 30, 1998, respectively, related primarily to professional fees and computer conversion cost resulting from the Company's 1998 acquisitions.



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

<TABLE>
<CAPTION>

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 1999 | 1998 | 1999 | 1998 |
| | (Unaudited) | | | |
| <S> | <C> | <C> | <C> | <C> |
| Salaries and Wages ...................................... | $ 4,491 | $ 3,444 | $ 8,364 | $ 7,258 |
| Employee Benefits ....................................... | 1,060 | 946 | 2,154 | 1,799 |
| Total Salaries and Employee Benefits .................. | 5,551 | 4,390 | 10,518 | 9,057 |
| Net Occupancy Expense ................................... | 1,008 | 842 | 1,993 | 1,620 |
| Equipment Expense ....................................... | 1,228 | 1,090 | 2,451 | 2,224 |
| Other Real Estate Income (Expense), Net | | | | |
| Rent Income ......................................... | (129) | (4) | (183) | (18) |
| (Gain) Loss on Sale ................................. | 35 | (199) | (172) | (233) |
| Expenses ............................................ | 196 | 137 | 536 | 240 |
| Write-Downs ......................................... | 1 | 5 | 15 | 5 |
| Total Other Real Estate Income (Expense), Net ........ | 103 | (61) | 196 | (6) |

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| | | | | |
|---|---|---|---|---|
| Amortization of Goodwill and Identifiable Intangibles | 679 | 681 | 1,359 | 1,302 |
| One Time Charge - Acquisitions | -- | 46 | -- | 728 |
| Other Noninterest Expense | | | | |
| Advertising and Public Relations | 279 | 299 | 660 | 621 |
| Data Processing and Check Clearing | 323 | 286 | 681 | 581 |
| Director Fees | 102 | 48 | 181 | 172 |
| Franchise Tax | 13 | 191 | 135 | 328 |
| Insurance | 134 | 102 | 235 | 194 |
| FDIC Insurance | 46 | 42 | 92 | 80 |
| Legal | 188 | 333 | 369 | 681 |
| Professional Fees | 175 | 156 | 394 | 329 |
| Postage, Delivery and Freight | 221 | 214 | 457 | 418 |
| Stationery and Supplies | 313 | 424 | 632 | 765 |
| Telephone | 131 | 127 | 273 | 259 |
| Other Losses | 18 | 110 | 45 | 166 |
| Miscellaneous Expense | 407 | 318 | 787 | 646 |
| Total Other Noninterest Expense | 2,350 | 2,650 | 4,941 | 5,240 |
| Total Noninterest Expense | $ 10,919 | $ 9,638 | $ 21,458 | $ 20,165 |

</TABLE>

INCOME TAX EXPENSE

The Company recorded income tax expense of $4.0 million for the three months ended June 30, 1999 compared to $3.6 million for the three months ended June 30, 1998. For the six months ended June 30, 1999, the provision for income taxes was $7.9 million, an increase of $1.0 million or 15.2% from $6.9 million provided for the same period in 1998. The increase in income tax expense is due primarily to an increased level of pretax income.

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 June 30, 1999, the Company exceeded all applicable capital requirements, having a total risk-based capital ratio of 13.79%, a Tier I risk-based capital ratio of 12.67%, and a leverage ratio of 8.93%.

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 and U.S. Government Agency and mortgage-



backed securities. At June 30, 1999, the Company's liquidity ratio, defined as cash, U.S. Treasury, U.S. Government Agency, mortgage-backed securities, time deposits and federal funds sold as a percentage of deposits, was 31.5% compared to 33.0% at December 31, 1998.

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. Federal funds purchased and short-term borrowings are additional sources of liquidity. These sources of liquidity are short-term in nature, and are used, as necessary, to fund asset growth and meet short-term liquidity needs.

During the six months ended June 30, 1999, funds for $126.7 million of securities purchases and $91.5 million of net loan growth came from various sources, including a net increase in deposits of $69.4 million and $106.6 million in proceeds from maturing securities and $14.5 million of net income.

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.

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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.

YEAR 2000 PROJECT

GENERAL

The Year 2000 problem affects all companies. This problem is rooted in storage constraints of systems developed in the 1960's and 1970's. Many computer codes used only two-digit year codes, e.g., 98 instead of four digits, 1998. Thus, many computer applications interpret the year "00" as 1900 and accordingly need to be modified to process in the next century.

In the early 1990's, management of Texas State Bank (the "Bank") decided to process all data in-house and offer data processing services to third party banks. As part of this initiative, management decided to purchase all critical software and support services from third party software vendors. All of the critical software purchased had already been coded to recognize a four-digit date. The Bank has no computer applications developed in-house.

STATE OF READINESS

In early 1997, the Bank established an ongoing corporate-wide effort to address the issues associated with the Year 2000. The Bank adopted the phased approach to Year 2000 project management as outlined by the Federal Financial Institutions Examination Council ("FFIEC"). The Bank's project goals are to meet if not exceed all Year 2000 regulatory guidelines. This approach requires the active involvement of management and the Board of Directors. This active management involvement provides the sponsorship and commitment to ensure the business issues and risks are adequately addressed and resolved. The FFIEC phases used are Awareness Phase, Assessment Phase, Renovation Phase, Validation Phase and Implementation Phase.



AWARENESS PHASE: DEFINE THE PROBLEM AND GAIN MANAGEMENT SUPPORT.

The Bank established a Year 2000 Committee comprised of all levels of management to address the Year 2000 project. An action plan was developed that includes strategies for dealing with in-house and third party computer systems, vendors, customers and business partners. An ongoing process to continually evaluate customers, business partners and management practices and policies will be phased in as the Year 2000 project evolves.

ASSESSMENT PHASE: ASSESS THE SIZE AND COMPLEXITY OF THE PROBLEM. EVALUATE RISK IMPACT AND ESTABLISH CONTINGENCY PLANS.

The Bank has essentially completed the assessment phase. Information Technology "(IT)" and Non IT systems have been identified. Systems have generally been identified as Core Mission critical, Non Mission critical and Business critical. Risk impact of material customers and other business partners are identified and due diligence procedures developed. The impact of strategic business initiatives, resources, needs and time lines have been addressed. A contingency plan for the Bank was completed on June 22, 1998 and addresses Core Mission critical and Business critical systems. Continually assessing risk is a major goal in the Year 2000 process.

RENOVATION PHASE: UPGRADE OR REPLACE NON-COMPLIANT SYSTEMS.

Core Mission critical software and hardware vendors of the Bank have represented their products as being Year 2000 compliant. The Bank is currently testing these products to corroborate the vendor representations. Certain Non Mission critical systems have been identified as not Year 2000 compliant. These systems will require the purchase of compliant systems from third party vendors.

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Renovation timelines have been established and all upgrades were completed by June 30, 1999.

VALIDATION PHASE: TESTING CURRENT AND UPGRADED SYSTEMS.

The Bank has created a Year 2000 Test Lab located in the Data Center to test many of the internal and external Core Mission critical systems. The Bank completed all internal Core Mission critical testing by September 30, 1998. In addition, the Bank has requested and received vendor representations that all Core Mission critical applications are Year 2000 compliant. The Data Center and appropriate operating departments at March 31, 1999 had completed interface testing with FEDLINE.

IMPLEMENTATION PHASE: SYSTEMS MUST BE YEAR 2000 READY BEFORE YEAR 2000.

In this phase, all systems should be fully renovated, tested and certified as Year 2000. If systems fail to meet Year 2000 requirements, contingency plans will be implemented. All systems were fully renovated and tested by June 30, 1999.

ESTIMATED COSTS

The Bank has estimated the total cost of the Year 2000 project at $500,000. The approximate cost expensed was $31,000 in 1997, $253,000 in 1998 and is estimated to be $216,000 in 1999.

RISK

Testing and planning do not ensure that any organization will be able to conduct business around and after the Year 2000. Testing does not ensure that the Bank's customers and other business partners will be able to conduct business. The Bank is performing due diligence on its customers and other business partners. Where our customers and business partners are regulated, we take comfort from knowing that this is a regulated entity and its regulator is doing its own due diligence. Where our customers and business partners are not regulated, the Bank implemented processes for evaluating readiness of customers and business partners for the Year 2000. These processes are continuously monitored.



CONTINGENCY PLAN

The Bank has implemented procedures and continues to refine its processes for evaluating its business readiness. Still, the possibility exists that something can go wrong. The Bank has prepared contingency plans to ensure a smooth flow of funds in the event of unforeseen problems. The effect of many business disruptions at the same time may impact the Bank. These contingency plans are reviewed continually to reasonably address these incidents.

Item 3. Quantitative and Qualitative Disclosures about Market Risks

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 is 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.

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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 12-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 12-month period as of June 30, 1999 and December 31, 1998 (dollars in thousands):

| Changes in Interest Rates (Basis Points) | Estimated Net Interest Income | Increase (Decrease) in Net Interest Income | |
|---|---|---|---|
| | | Amount | Percent |
| | | (Unaudited) | |
| June 30, 1999 | | | |
| +100 | $82,657 | $1,529 | 1.9% |
| - | 81,128 | - | - |
| -100 | 78,110 | (3,018) | (3.7) |
| December 31, 1998 | | | |
| +100 | 77,223 | 2,317 | 3.1 |
| - | 74,906 | - | - |
| -100 | 69,940 | (4,966) | (6.6) |

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.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The Company is involved in routine litigation in the normal course of its business, which in the opinion of management, will not have a material adverse effect on the financial condition or results of operations of the Company.

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

None

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None

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

The Annual Meeting of Shareholders of the Corporation was held on April 26, 1999. The following matter was submitted to a vote of the Corporation's shareholders.

Election of all seven director nominees was approved.

<TABLE>
<CAPTION>

| Nominee | Total Votes For | Total Votes Withheld | Total Votes Against |
|---|---|---|---|
| <S> | <C> | <C> | |
| Morris Atlas | 12,944,723 | 23,562 | - |
| Frank N. Boggus | 12,958,799 | 9,486 | - |

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| | | | |
|---|---|---|---|
| Robert G. Farris | 12,958,799 | 9,486 | - |
| C. Kenneth Landrum, M.D. | 12,958,799 | 9,486 | - |
| Glen E. Roney | 12,957,943 | 10,342 | - |
| Julie G. Uhlhorn | 12,958,799 | 9,486 | - |
| Jack Whetsel | 12,958,799 | 9,486 | - |

</TABLE>

ITEM 5. OTHER INFORMATION.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

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

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

27 Financial Data Schedule

(b) Reports of Form 8-K

No report on Form 8-K was filed by Texas Regional Bancshares, Inc. during the three months ended June 30, 1999.



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)

July 27, 1999 /s/ G. E. Roney

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

July 27, 1999 /s/ R. T. Pigott, Jr.

R. T. Pigott, Jr.
Executive Vice President
& Chief Financial Officer



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```
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This schedule contains summary financial information extracted from the
Consolidated Balance Sheets and Consolidated Statements of Income, included
herein and is qualified in its entirety by reference to such financial
statements.
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