FIRST BANCORP /PR/
Form 10-Q
September 24, 2007

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, DC 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2007**

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

**For the transition period from __________ to __________**

**COMMISSION FILE NUMBER 0-17224**

**FIRST BANCORP.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| | |
|---|---|
| Puerto Rico<br>(State or other jurisdiction of<br>incorporation or organization) | 66-0561882<br>(I.R.S. employer<br>identification number) |
| 1519 Ponce de León Avenue, Stop 23<br>Santurce, Puerto Rico<br>(Address of principal executive offices) | 00908<br>(Zip Code) |

(787) 729-8200

(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 o No þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in rule 12b-2 of the Exchange Act).

Large accelerated þ filer Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act).

Yes o No þ

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

Common stock: 92,504,506 outstanding as of August 31, 2007.

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## EXPLANATORY NOTE

First BanCorp ( the Corporation or First BanCorp ) was unable to timely file with the Securities and Exchange Commission ( SEC ) this Quarterly Report on Form 10-Q for the interim period ended June 30, 2007 as a result of the delay in completing the restatement of the Corporation s audited financial statements for the years ended December 31, 2004, 2003 and 2002, and the unaudited selected quarterly financial information for each of the four quarters of 2004, 2003 and 2002, which resulted in delays in the filing of an amendment of First BanCorp s Annual Report on Form 10-K for the year ended December 31, 2004 and consequent delays in the filing of the Corporation s subsequent reports. For information regarding the restatement of First BanCorp s previously issued financial statements, see the Corporation s Amendment No. 1 to Annual Report on Form 10-K/A for the year ended December 31, 2004, which was filed with the SEC on September 26, 2006.

## FORWARD LOOKING STATEMENTS

This Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When used in this Form 10-Q or future filings by First BanCorp with the SEC, in the Corporation s press releases or in other public or shareholder communications, or in oral statements made with the approval of an authorized executive officer, the word or phrases would be, will allow, intends to, will likely result, expected to, should, anticipate and similar expressions are meant to identify forward-looking statements.

First BanCorp wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made, and represent First BanCorp s expectations of future conditions or results and are not guarantees of future performance. First BanCorp advises readers that various factors could cause actual results to differ materially from those contained in any forward-looking statement. Such factors include, but are not limited to, the following:

- risks associated with the Corporation s inability to prepare and timely submit SEC and other regulatory filings;

- an adverse change in the Corporation s ability to attract new clients and retain existing ones;

- general economic conditions, including prevailing interest rates and the performance of the financial markets, which may affect demand for the Corporation s products and services and the value of the Corporation s assets, including the value of the interest rate swaps that economically hedge the interest rate risk mainly relating to brokered certificates of deposit and medium-term notes;

- risks arising from worsening economic conditions in Puerto Rico and in the South Florida market;

- risks arising from credit and other risks of the Corporation s lending and investment activities, including the condo conversion loans in its Miami Agency;

- increases in the Corporation s expenses associated with acquisitions and dispositions;

- developments in technology;

- risks associated with changes to the Corporation s business strategy to no longer acquire mortgage loans in bulk;

- risks associated with the failure to obtain a final order from the District Court of Puerto Rico approving the settlement of the class action lawsuit brought against the Corporation;

- the impact of Doral Financial Corporation and R&G Financial Corporation s financial condition on the repayment of their outstanding secured loan to the Corporation;

- risks associated with being subject to the cease and desist orders;

the Corporation s ability to issue brokered certificates of deposit and the ability to fund operations;

potential further downgrades in the credit ratings of the Corporation s securities;

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- general competitive factors and industry consolidation; and
- risks associated with regulatory and legislative changes for financial services companies in Puerto Rico, the United States, and the U.S. and British Virgin Islands.

The Corporation does not undertake, and specifically disclaims any obligation, to update any of the forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements except as required by the federal securities laws.

Investors should carefully consider these factors and the risk factors outlined under Item 1A, Risk Factors, in First BanCorp s 2006 Annual Report on Form 10-K and under Item 1A, Risk Factors, in this Quarterly Report on Form 10-Q.

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**FIRST BANCORP**
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**
(Unaudited)

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 134,955,243 | $ 112,340,615 |
| Money market instruments, including, for 2007, $4,602,509 of collateral pledged that can be repledged | 426,786,590 | 377,296,017 |
| Federal funds sold and securities purchased under agreements to resell | 222,806,260 | 42,051,281 |
| Time deposits with other financial institutions | 58,862,956 | 37,123,111 |
| Total money market investments | 708,455,806 | 456,470,409 |
| Investment securities available for sale, at fair value: | | |
| Securities pledged that can be repledged | 1,151,251,901 | 1,373,466,630 |
| Other investment securities | 581,861,986 | 326,956,340 |
| Total investment securities available for sale | 1,733,113,887 | 1,700,422,970 |
| Investment securities held to maturity, at amortized cost: | | |
| Securities pledged that can be repledged | 2,451,058,790 | 2,661,088,022 |
| Other investment securities | 850,562,409 | 686,042,717 |
| Total investment securities held to maturity, fair value of $3,185,886,393 (2006 - $3,256,965,610) | 3,301,621,199 | 3,347,130,739 |
| Other equity securities | 43,578,685 | 40,159,185 |
| Loans, net of allowance for loan and lease losses of $165,009,429 (December 31, 2006 - $158,295,662) | 11,057,640,411 | 11,070,446,401 |
| Loans held for sale, at lower of cost or market | 26,029,830 | 35,238,127 |
| Total loans, net | 11,083,670,241 | 11,105,684,528 |
| Premises and equipment, net | 158,821,017 | 155,661,727 |
| Other real estate owned | 6,280,266 | 2,869,713 |
| Accrued interest receivable on loans and investments | 114,826,772 | 112,505,003 |
| Due from customers on acceptances | 89,454 | 149,716 |
| Other assets | 319,632,387 | 356,861,273 |
| Total assets | $ 17,605,044,957 | $ 17,390,255,878 |
| **Liabilities & Stockholders Equity** | | |
| Liabilities: | | |

| | | |
|---|---|---|
| Non-interest-bearing deposits | $ 642,833,774 | $ 790,985,153 |
| Interest-bearing deposits (includes $4,316,391,667 measured at fair value as of June 30, 2007) | 10,990,097,378 | 10,213,302,047 |
| Federal funds purchased and securities sold under agreements to repurchase | 3,265,763,000 | 3,687,724,000 |
| Advances from the Federal Home Loan Bank (FHLB) | 625,000,000 | 560,000,000 |
| Notes payable (includes $14,666,448 measured at fair value as of June 30, 2007) | 32,216,289 | 182,827,572 |
| Other borrowings | 231,767,698 | 231,719,406 |
| Bank acceptances outstanding | 89,454 | 149,716 |
| Accounts payable and other liabilities | 510,965,060 | 493,994,798 |
| Total liabilities | 16,298,732,653 | 16,160,702,692 |
| Commitments and contingencies (Note 16) | | |
| Stockholders equity: | | |
| Preferred stock, authorized 50,000,000 shares: issued and outstanding 22,004,000 shares at $25 liquidation value per share | 550,100,000 | 550,100,000 |
| Common stock, $1 par value, authorized 250,000,000 shares; issued 93,151,856 shares | 93,151,856 | 93,151,856 |
| Less: Treasury stock (at par value) | (9,897,800) | (9,897,800) |
| Common stock outstanding | 83,254,056 | 83,254,056 |
| Additional paid-in capital | 25,604,944 | 22,756,994 |
| Legal surplus | 276,847,825 | 276,847,825 |
| Retained earnings | 430,758,738 | 326,761,462 |
| Accumulated other comprehensive loss, net of tax benefit of $426,086 (December 31, 2006 - $221,389) | (60,253,259) | (30,167,151) |
| Total stockholders equity | 1,306,312,304 | 1,229,553,186 |
| Total liabilities and stockholders equity | $ 17,605,044,957 | $ 17,390,255,878 |

The accompanying notes are an integral part of these statements.

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**FIRST BANCORP**
**CONSOLIDATED STATEMENTS OF INCOME**
**(Unaudited)**

| | Quarter Ended | | Six-Month Period Ended | |
|---|---|---|---|---|
| | June 30, 2007 | June 30, 2006 | June 30, 2007 | June 30, 2006 |
| **Interest income:** | | | | |
| Loans | $ 228,911,146 | $ 247,603,929 | $ 454,549,837 | $ 493,693,236 |
| Investment securities | 71,672,690 | 72,040,513 | 139,344,411 | 143,681,230 |
| Money market investments | 5,288,285 | 24,799,009 | 10,562,355 | 34,773,873 |
| Total interest income | 305,872,121 | 344,443,451 | 604,456,603 | 672,148,339 |
| **Interest expense:** | | | | |
| Deposits (Note 10) | 133,882,215 | 157,153,731 | 257,971,740 | 343,991,804 |
| Federal funds purchased and repurchase agreements | 39,389,847 | 51,133,513 | 81,159,876 | 104,699,042 |
| Advances from FHLB | 9,001,211 | 2,867,071 | 17,198,452 | 7,044,803 |
| Notes payable and other borrowings | 6,383,104 | 7,051,194 | 13,476,019 | 17,356,139 |
| Total interest expense | 188,656,377 | 218,205,509 | 369,806,087 | 473,091,788 |
| Net interest income | 117,215,744 | 126,237,942 | 234,650,516 | 199,056,551 |
| **Provision for loan and lease losses** | 24,627,867 | 9,354,590 | 49,542,335 | 28,730,477 |
| Net interest income after provision for loan and lease losses | 92,587,877 | 116,883,352 | 185,108,181 | 170,326,074 |
| **Non-interest income:** | | | | |
| Other service charges on loans | 2,417,637 | 1,467,127 | 4,208,729 | 2,953,397 |
| Service charges on deposit accounts | 3,185,040 | 3,278,109 | 6,376,132 | 6,555,138 |
| Mortgage banking activities gain (loss) | 350,527 | 427,171 | 1,112,598 | (147,676) |
| Net (loss) gain on investments and impairments | (1,436,500) | 134,224 | (3,595,191) | (574,544) |
| Net gain (loss) on partial extinguishment and recharacterization of secured commercial loans to local financial institutions | | (11,640,344) | 2,497,166 | (11,640,344) |
| Rental income | 669,942 | 837,380 | 1,333,438 | 1,610,670 |
| Gain on sale of credit card portfolio | | | 2,818,972 | |
| Other operating income | 5,716,324 | 7,279,281 | 11,973,446 | 13,614,497 |
| Total non-interest income | 10,902,970 | 1,782,948 | 26,725,290 | 12,371,138 |

| | | | | |
|---|---|---|---|---|
| **Non-interest expenses:** | | | | |
| Employees compensation and benefits | 33,351,215 | 29,869,779 | 69,723,605 | 63,994,700 |
| Occupancy and equipment | 14,495,615 | 13,623,498 | 28,878,023 | 26,329,588 |
| Business promotion | 4,863,746 | 4,324,181 | 9,794,214 | 8,098,241 |
| Professional fees | 5,608,596 | 10,143,207 | 12,005,114 | 17,536,173 |
| Taxes, other than income taxes | 3,652,962 | 2,558,071 | 7,234,297 | 5,113,340 |
| Insurance and supervisory fees | 1,798,686 | 1,909,550 | 3,490,426 | 3,610,562 |
| Other operating expenses | 9,683,869 | 8,611,833 | 21,692,736 | 18,095,170 |
| Total non-interest expenses | 73,454,689 | 71,040,119 | 152,818,415 | 142,777,774 |
| **Income before income taxes** | 30,036,158 | 47,626,181 | 59,015,056 | 39,919,438 |
| **Income tax provision** | (6,240,676) | (15,823,679) | (12,387,589) | (4,253,694) |
| **Net income** | $ 23,795,482 | $ 31,802,502 | $ 46,627,467 | $ 35,665,744 |
| **Net income attributable to common stockholders** | $ 13,726,483 | $ 21,733,503 | $ 26,489,469 | $ 15,527,746 |
| **Net income per common share:** | | | | |
| Basic | $ 0.16 | $ 0.26 | $ 0.32 | $ 0.19 |
| Diluted | $ 0.16 | $ 0.26 | $ 0.32 | $ 0.19 |
| **Dividends declared per common share** | $ 0.07 | $ 0.07 | $ 0.14 | $ 0.14 |

The accompanying notes are an integral part of these statements.

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**FIRST BANCORP**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**

| | Six-Month Period Ended June 30, 2007 | Six-Month Period Ended June 30, 2006 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income | $ 46,627,467 | $ 35,665,744 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 8,393,859 | 8,355,081 |
| Amortization of core deposit intangible | 1,659,863 | 1,778,206 |
| Provision for loan and lease losses | 49,542,335 | 28,730,477 |
| Deferred income tax benefit | (2,013,334) | (26,536,609) |
| Stock-based compensation recognized | 2,847,950 | 4,892,361 |
| Loss (gain) on sale of investments, net | 732,301 | (2,375,344) |
| Other-than-temporary impairments on available-for-sale securities | 2,862,890 | 2,949,888 |
| Derivative instruments and hedging activities loss | 363,122 | 66,808,911 |
| Net (gain) loss on sale of loans and impairments | (605,809) | 412,663 |
| Net (gain) loss on partial extinguishment and recharacterization of secured commercial loans to local financial institutions | (2,497,166) | 11,640,344 |
| Net amortization of premiums and discounts and deferred loan fees and costs | (1,042,987) | (921,749) |
| Amortization of broker placement fees | 4,764,937 | 8,718,909 |
| (Accretion) amortization of basis adjustments on fair value hedges | (2,060,686) | 1,303,698 |
| Net accretion of discount and premiums on investment securities | (18,245,821)) | (17,820,409) |
| Gain on sale of credit card portfolio | (2,818,972) | |
| Increase (decrease) in accrued income tax payable | 9,962,943 | (8,693,921) |
| (Increase) decrease in accrued interest receivable | (2,451,369) | 5,259,986 |
| (Decrease) increase in accrued interest payable | (26,808,725) | 36,556,819 |
| Decrease (increase) in other assets | 621,632 | (17,486,355) |
| (Decrease) increase in other liabilities | (4,016,821) | 17,472,725 |
| Total adjustments | 19,190,142 | 121,045,681 |
| Net cash provided by operating activities | 65,817,609 | 156,711,425 |
| **Cash flows from investing activities:** | | |
| Principal collected on loans | 1,607,936,801 | 4,338,010,938 |
| Loans originated | (1,807,981,499) | (2,553,227,124) |
| Purchase of loans | (99,533,154) | (106,750,392) |
| Proceeds from sale of loans | 69,844,306 | 36,900,103 |
| Proceeds from sale of repossessed assets | 27,903,751 | 20,920,391 |
| Purchase of servicing assets | (1,035,952) | (378,823) |
| Proceeds from sale of available for sale securities | 3,125,310 | 22,846,966 |
| Purchase of securities held to maturity | (254,586,376) | (208,568,307) |

| | | |
|---|---|---|
| Purchase of securities available for sale | | (21,401,938) |
| Principal repayments and maturities of securities held to maturity | 318,094,294 | 378,026,709 |
| Principal repayments of securities available for sale | 112,920,850 | 113,168,384 |
| Additions to premises and equipment | (11,553,149) | (15,966,355) |
| (Increase) decrease in other equity securities | (3,419,500) | 18,678,315 |
| Net cash (used in) provided by investing activities | (38,284,318) | 2,022,258,867 |
| **Cash flows from financing activities:** | | |
| Net increase in deposits | 785,821,301 | 1,091,566,504 |
| Net decrease in federal funds purchased and securities sold under repurchase agreements | (421,961,000) | (811,196,500) |
| Net FHLB advances taken (paid) | 65,000,000 | (312,000,000) |
| Repayments of notes payable and other borrowings | (150,000,000) | |
| Dividends paid | (31,793,567) | (31,772,568) |
| Exercise of stock options | | 19,756,483 |
| Net cash provided by (used in) financing activities | 247,066,734 | (43,646,081) |
| Net increase in cash and cash equivalents | 274,600,025 | 2,135,324,211 |
| Cash and cash equivalents at beginning of period | 568,811,024 | 1,380,640,086 |
| Cash and cash equivalents at end of period | $ 843,411,049 | $ 3,515,964,297 |
| Cash and cash equivalents include: | | |
| Cash and due from banks | $ 134,955,243 | $ 154,078,088 |
| Money market instruments | 708,455,806 | 3,361,886,209 |
| | $ 843,411,049 | $ 3,515,964,297 |
| **Supplemental disclosures of cash flow information:** | | |
| Cash paid during the period for: | | |
| Interest on borrowings | $ 386,144,903 | $ 353,284,025 |
| Income taxes | 3,255,376 | 37,680,255 |
| Non-cash investing and financing activities: | | |
| Additions to other real estate owned | $ 4,906,985 | $ 1,569,586 |
| Additions to auto repossessions | 57,697,924 | 52,739,918 |
| Capitalization of servicing assets | 594,640 | 235,191 |
| Recharacterization of secured commercial loans as securities collateralized by loans | 183,829,925 | |

The accompanying notes are an integral part of these statements.

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**FIRST BANCORP**
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**
**(Unaudited)**

| | Six-Month Period Ended | |
|---|---|---|
| | **June 30, 2007** | **June 30, 2006** |
| **Preferred Stock** | $ 550,100,000 | $ 550,100,000 |
| | | |
| **Common Stock outstanding:** | | |
| Balance at beginning of period | 83,254,056 | 80,875,056 |
| Common stock issued under stock option plan | | 2,379,000 |
| Balance at end of period | 83,254,056 | 83,254,056 |
| | | |
| **Additional Paid-In-Capital:** | | |
| Balance at beginning of period | 22,756,994 | |
| Shares issued under stock option plan | | 17,377,483 |
| Stock-based compensation recognized | 2,847,950 | 4,892,361 |
| Balance at end of period | 25,604,944 | 22,269,844 |
| | | |
| **Legal Surplus** | 276,847,825 | 265,844,192 |
| | | |
| **Retained Earnings:** | | |
| Balance at beginning of period | 326,761,462 | 316,696,971 |
| Net income | 46,627,467 | 35,665,744 |
| Cash dividends declared on common stock | (11,655,569) | (11,634,570) |
| Cash dividends declared on preferred stock | (20,137,998) | (20,137,998) |
| Cumulative adjustment for accounting change (adoption of FIN 48) | (2,614,795) | |
| Cumulative adjustment for accounting change (adoption of SFAS No. 159) | 91,778,171 | |
| Balance at end of period | 430,758,738 | 320,590,147 |
| | | |
| **Accumulated Other Comprehensive Loss, net of tax:** | | |
| Balance at beginning of period | (30,167,151) | (15,675,284) |
| Other comprehensive loss, net of tax | (30,086,108) | (66,959,980) |
| Balance at end of period | (60,253,259) | (82,635,264) |
| | | |
| Total stockholders equity | $ 1,306,312,304 | $ 1,159,422,975 |

The accompanying notes are an integral part of these statements.

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**FIRST BANCORP**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME**
**(Unaudited)**

| | Quarter Ended | | Six-Month Period Ended | |
|---|---|---|---|---|
| | June 30, 2007 | June 30, 2006 | June 30, 2007 | June 30, 2006 |
| Net income | $ 23,795,482 | $ 31,802,502 | $ 46,627,467 | $ 35,665,744 |
| Other comprehensive loss: | | | | |
| Unrealized loss on securities: | | | | |
| Unrealized holding loss arising during the period | (32,018,023) | (36,633,176) | (33,885,996) | (68,428,461) |
| Less: Reclassification adjustments for net loss (gain) and other than temporary impairments included in net income | 1,436,500 | (134,224) | 3,595,191 | 574,544 |
| Income tax benefit related to items of other comprehensive income | 229,509 | 623,433 | 204,697 | 893,937 |
| Other comprehensive loss for the period, net of tax | (30,352,014) | (36,143,967) | (30,086,108) | (66,959,980) |
| Total comprehensive (loss) income | $ (6,556,532) | $ (4,341,465) | $ 16,541,359 | $ (31,294,236) |

The accompanying notes are an integral part of these statements.

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**FIRST BANCORP**
**PART I NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**(UNAUDITED)**

**1 BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

The Consolidated Financial Statements (unaudited) have been prepared in conformity with the accounting policies stated in the Corporation s Annual Audited Financial Statements included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2006. Certain information and note disclosures normally included in the financial statements prepared in accordance with generally accepted accounting principles in the United States of America ( GAAP ) have been condensed or omitted from these statements pursuant to the rules and regulations of the SEC and, accordingly, these financial statements should be read in conjunction with the audited Consolidated Financial Statements of the Corporation for the year ended December 31, 2006, included in the Corporation s 2006 Annual Report on Form 10-K. All adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the statement of financial position, results of operations and cash flows for the interim periods have been reflected. All significant intercompany accounts and transactions have been eliminated in consolidation.

The results of operations for the quarter and six-month period ended June 30, 2007, are not necessarily indicative of the results to be expected for the entire year.

**Recently issued accounting pronouncements**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. ( SFAS ) 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 . This Statement allows entities to choose to measure certain financial assets and liabilities at fair value with changes in fair value reflected in earnings. The fair value option may be applied on an instrument-by-instrument basis. This Statement is effective for periods after November 15, 2007, however, early adoption is permitted provided that the entity also elects to apply the provisions of SFAS 157, Fair Value Measurements . The Corporation adopted SFAS 159 and SFAS 157 effective January 1, 2007. The Corporation decided to early adopt SFAS 159 for the callable brokered certificates of deposit ( CDs ) and a portion of the callable fixed medium-term notes, both of which were hedged with interest rate swaps. First BanCorp had been following the long-haul method of accounting, which was adopted on April 3, 2006, under SFAS 133, Accounting for Derivative Instruments and Hedging Activities , for the portfolio of callable interest rate swaps, callable brokered CDs and callable notes. One of the main considerations in determining to early adopt SFAS 159 for these instruments was to eliminate the operational procedures required by the long-haul method of accounting in terms of documentation, effectiveness assessment, and manual procedures followed by the Corporation to fulfill the requirements specified by SFAS 133.

Upon adoption of SFAS 159, the Corporation selected the fair value measurement for approximately $4.4 billion, or 63%, of the brokered CDs portfolio and approximately $15.4 million, or 9%, of the medium-term notes portfolio ( SFAS 159 liabilities ). Interest rate risk on the brokered CDs and medium-term notes chosen for the fair value measurement option will continue to be economically hedged through callable interest rate swaps with the same terms and conditions. The cumulative after-tax effect on the opening balance of retained earnings from adopting these standards was an approximate increase of $91.8 million. Under SFAS 159, this one-time credit was not recognized in current earnings.

With the Corporation s elimination of the use of the long-haul method in connection with the adoption of SFAS 159, the Corporation will no longer amortize or accrete the basis adjustment for the SFAS 159 liabilities. The basis adjustment amortization or accretion is the reversal of the change in value of the hedged brokered CDs and medium-term notes recognized since the implementation of the long-haul method. Since the time the Corporation implemented the long-haul method, it has recognized the basis adjustment and the changes in the value of the hedged brokered CDs and medium-term notes based on the expected call date of the instruments. The adoption of SFAS 159 also requires the recognition, as part of the initial adoption adjustment to retained earnings, of all of the unamortized placement fees that were paid to broker counterparties upon the issuance of the elected brokered CDs and medium-term notes. The Corporation previously amortized those fees through earnings based on the expected call date of the instruments. SFAS 159 also establish that the accrued interest should be reported as part of the fair value of the financial instruments elected to be measured at fair value. The impact of the derecognition of the basis adjustment and the unamortized placement fees as of January 1, 2007 results in a cumulative after-tax reduction to retained earnings of approximately $23.9 million. This negative charge was included in the total cumulative after-tax increase to retained earnings of $91.8 million that resulted with the adoption of SFAS 157 and SFAS 159.

In September 2006, the FASB issued SFAS 157, Fair Value Measurement . This Statement defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. This Statement is effective for periods beginning after November 15, 2007. Effective January 1, 2007, the Corporation elected to early adopt this Statement. For further details and for the effect on the Corporation s financial condition and results of operations upon adoption of SFAS 157 and SFAS 159, refer to Note 14 to these interim unaudited consolidated financial statements.

In June 2006, the FASB issued Financial Interpretation No. ( FIN ) 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . This interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS 109, Accounting for Income Taxes . This interpretation provides a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation is effective for periods beginning after December 15, 2006. The Corporation adopted FIN 48 effective January 1, 2007. Refer to Note 13 to these interim unaudited consolidated financial statements for required disclosures and further information on the impact of the adoption of this accounting pronouncement.

In March 2006, the FASB issued SFAS 156, Accounting for Servicing of Financial Assets, an amendment of SFAS 140. This Statement allows servicing assets and servicing liabilities to be initially measured at fair value along with any derivative instruments used to mitigate inherent risks. This Statement is effective for fiscal years beginning after September 15, 2006. The adoption of this Statement in 2007 did not have a material effect on the Corporation s financial condition and results of operations as the Corporation continues to utilize the amortization method.

On April 30, 2007, the FASB issued FASB Staff Position No. FIN 39-1 ( FSP FIN 39-1 ), which amends FASB interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39) . FSP FIN 39-1 impacts entities that enter into master netting arrangements as part of their derivative transactions by allowing net derivative positions to be offset in the financial statements against the fair value of amounts (or amounts that approximate fair value) recognized for the right to reclaim cash collateral or the obligation to return cash collateral under those arrangements. FSP FIN 39-1 is effective for fiscal years beginning after November 15, 2007, although early application is permitted. The Corporation is currently evaluating the effect, if any, of the adoption of FSP FIN 39-1 on its Financial Statements, commencing on January 1, 2008.

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## 2 EARNINGS PER COMMON SHARE

The calculations of earnings per common share for the quarters and six-month periods ended on June 30, 2007 and 2006 are as follows:

| | Quarter Ended June 30, | | Six-Month Period Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (In thousands, except per share data) | | | |
| **Net Income:** | | | | |
| Net Income | $ 23,795 | $ 31,803 | $ 46,627 | $ 35,666 |
| Less: Preferred stock dividend | (10,069) | (10,069) | (20,138) | (20,138) |
| Net income available to common stockholders | $ 13,726 | $ 21,734 | $ 26,489 | $ 15,528 |
| **Weighted-Average Shares:** | | | | |
| Basic weighted average common shares outstanding | 83,254 | 83,254 | 83,254 | 82,410 |
| Average potential common shares | 622 | 158 | 503 | 498 |
| Diluted weighted average number of common shares outstanding | 83,876 | 83,412 | 83,757 | 82,908 |
| **Earnings per common share:** | | | | |
| Basic | $ 0.16 | $ 0.26 | $ 0.32 | $ 0.19 |
| Diluted | $ 0.16 | $ 0.26 | $ 0.32 | $ 0.19 |

Potential common shares consist of common stock issuable under the assumed exercise of stock options using the treasury stock method. This method assumes that the potential common shares are issued and the proceeds from exercise are used to purchase common stock at the exercise date. The difference between the number of potential shares issued and the shares purchased is added as incremental shares to the actual number of shares outstanding to compute diluted earnings per share. Stock options that result in lower potential shares issued than shares purchased under the treasury stock method are not included in the computation of dilutive earnings per share since their inclusion would have an antidilutive effect in earnings per share. For the quarter and six-month period ended June 30, 2007, a total of 2,054,600 stock options were not included in the computation of dilutive earnings per share since their inclusion would have an antidilutive effect on earnings per share.

## 3 STOCK OPTION PLAN

Since 1997, the Corporation has had a stock option plan ( the 1997 stock option plan ) covering certain employees. This plan allowed for the granting of up to 8,696,112 purchase options on shares of the Corporation s common stock to certain employees. According to the plan, the options granted cannot exceed 20% of the number of common shares outstanding. Each option provides for the purchase of one share of common stock at a price not less than the fair market value of the stock on the date the option is granted. Stock options are fully vested upon issuance. The maximum term to exercise the options is ten years. The stock option plan provides for a proportionate adjustment in the exercise price and the number of shares that can be purchased in the event of a stock dividend, stock split, reclassification of stock, merger or reorganization and certain other issuances and distributions such as stock appreciation rights.

Under the Corporation s stock option plan, the Compensation Committee had the authority to grant stock appreciation rights at any time subsequent to the grant of an option. Pursuant to the stock appreciation rights, the Optionee surrenders the right to exercise an option granted under the plan in consideration for payment by the Corporation of an amount equal to the excess of the fair market value of the shares of common stock subject to such option surrendered over the total option price of such shares. Any option surrendered shall be cancelled by the Corporation and the shares subject to the option shall not be eligible for further grants under the option plan. The 1997 stock option plan expired in the first quarter of 2007.

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On January 1, 2006, the Corporation adopted SFAS 123R, Share-Based Payment using the modified prospective method. Using this method, and since all previously issued stock options were fully vested at the time of the adoption, the Corporation expenses the fair value of all employee stock options granted after January 1, 2006 (same as the prospective method). The compensation expense associated with stock options for the six-month periods ended June 30, 2007 and 2006 was approximately $2.8 million and $4.9 million, respectively. All employee stock options granted during 2007 and 2006 were fully vested at the time of grant.

The activity of stock options during the first six-months of 2007 is set forth below:

| | Six-Month Period Ended June 30, 2007 | | | |
|---|---|---|---|---|
| | Number of Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (In thousands) |
| Beginning of period | 3,024,410 | $ 13.95 | | |
| Options granted | 1,170,000 | 9.20 | | |
| End of period outstanding and exercisable | 4,194,410 | $ 12.63 | 7.4 | $ 4,403 |

The fair value of options granted in 2007 and 2006, that was estimated using the Black-Scholes option pricing, and the assumptions used are as follows:

| | 2007 | 2006 |
|---|---|---|
| Weighted average stock price at grant date and exercise price | $ 9.20 | $ 12.68 |
| Stock option estimated fair value | $ 2.40 $2.45 | $ 4.56 $4.60 |
| Weighted-average estimated fair value | $ 2.43 | $ 4.57 |
| Expected stock option term (years) | 4.31 4.59 | 4.22 4.31 |
| Expected volatility | 32% | 46% |
| Expected dividend yield | 3.0% | 2.2% |
| Risk-free interest rate | 5.1% | 4.7% 5.0% |

The Corporation uses empirical research data to estimate option exercises and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected volatility is based on the historical implied volatility of the Corporation s common stock at each grant date. The dividend yield is based on the historical 12-month dividend yield observable at each grant date. The risk-free rate for the periods is based on historical zero coupon curves obtained from Bloomberg L.P. at the time of grant based on the option expected term.

No stock options were exercised during the first half of 2007. The total intrinsic value of options exercised during the first half of 2006 was approximately $10.0 million. Cash proceeds from options exercised during the first half of 2006 amounted to approximately $19.8 million.

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## 4 INVESTMENT SECURITIES

### Investment Securities Available for Sale

The amortized cost, gross unrealized gains and losses, approximate fair value, weighted-average yield and contractual maturities of investment securities available for sale as of June 30, 2007 and December 31, 2006 were as follows:

| | June 30, 2007 | | | | | December 31, 2006 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Amortized cost | Gross Unrealized gains | Gross Unrealized losses | Fair value | Weighted average yield% | Amortized cost | Gross Unrealized gains | Gross Unrealized losses | Fair value | Weighted average yield% |
| | (Dollars in thousands) | | | | | | | | | |
| Obligations of U.S. Government sponsored agencies: | | | | | | | | | | |
| After 5 to 10 years | $ 401,874 | $ | $ 18,815 | $ 383,059 | 4.30 | $ 402,542 | $ 6 | $ 11,820 | $ 390,728 | 4.31 |
| After 10 years | 12,984 | | 166 | 12,818 | 6.16 | 12,984 | | 120 | 12,864 | 6.16 |
| Puerto Rico Government obligations: | | | | | | | | | | |
| After 1 to 5 years | 5,210 | 124 | | 5,334 | 6.23 | 4,635 | 126 | | 4,761 | 6.18 |
| After 5 to 10 years | 15,580 | 102 | 524 | 15,158 | 4.85 | 15,534 | 219 | 508 | 15,245 | 4.86 |
| After 10 years | 4,948 | 41 | 254 | 4,735 | 5.86 | 5,376 | 98 | 178 | 5,296 | 5.88 |
| United States and Puerto Rico Government obligations | 440,596 | 267 | 19,759 | 421,104 | 4.42 | 441,071 | 449 | 12,626 | 428,894 | 4.43 |
| Mortgage-backed securities: | | | | | | | | | | |
| FHLMC certificates: | | | | | | | | | | |
| Within 1 year | 70 | | | 70 | 5.52 | 82 | | | 82 | 5.99 |
| After 1 to 5 years | 1,100 | 26 | | 1,126 | 6.94 | 1,666 | 36 | | 1,702 | 6.98 |
| After 10 years | 5,487 | 44 | 243 | 5,288 | 5.62 | 5,846 | 55 | 110 | 5,791 | 5.61 |
| | 6,657 | 70 | 243 | 6,484 | 5.85 | 7,594 | 91 | 110 | 7,575 | 5.92 |
| GNMA certificates: | | | | | | | | | | |
| After 1 to 5 years | 655 | 7 | | 662 | 6.49 | 866 | 10 | | 876 | 6.44 |
| After 5 to 10 years | 799 | 4 | 5 | 798 | 5.87 | 795 | 3 | 3 | 795 | 5.53 |
| After 10 years | 350,976 | 287 | 14,747 | 336,516 | 5.26 | 379,363 | 470 | 7,136 | 372,697 | 5.26 |
| | 352,430 | 298 | 14,752 | 337,976 | 5.26 | 381,024 | 483 | 7,139 | 374,368 | 5.26 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| FNMA certificates: | | | | | | | | | | |
| After 1 to 5 years | 58 | 1 | | 59 | 7.22 | 90 | | | 90 | 7.34 |
| After 5 to 10 years | 31,557 | 10 | 941 | 30,626 | 4.78 | 18,040 | 10 | 305 | 17,745 | 4.87 |
| After 10 years | 778,579 | 530 | 23,990 | 755,119 | 5.18 | 864,508 | 673 | 11,476 | 853,705 | 5.18 |
| | 810,194 | 541 | 24,931 | 785,804 | 5.16 | 882,638 | 683 | 11,781 | 871,540 | 5.17 |
| Mortgage pass-through certificates: | | | | | | | | | | |
| After 10 years | 172,520 | 176 | 708 | 171,988 | 5.92 | 367 | 3 | | 370 | 7.28 |
| Mortgage-backed securities | 1,341,801 | 1,085 | 40,634 | 1,302,252 | 5.29 | 1,271,623 | 1,260 | 19,030 | 1,253,853 | 5.21 |
| Corporate bonds: | | | | | | | | | | |
| After 5 to 10 years | 1,300 | | 85 | 1,215 | 7.70 | 1,300 | | 83 | 1,217 | 7.70 |
| After 10 years | 4,411 | | 688 | 3,723 | 7.97 | 4,412 | | 668 | 3,744 | 7.97 |
| Corporate bonds | 5,711 | | 773 | 4,938 | 7.90 | 5,712 | | 751 | 4,961 | 7.91 |
| Equity securities (without contractual maturity) | 5,686 | | 866 | 4,820 | 0.07 | 12,406 | 452 | 143 | 12,715 | 3.70 |
| Total investment securities available for sale | $ 1,793,794 | $ 1,352 | $ 62,032 | $ 1,733,114 | 5.07 | $ 1,730,812 | $ 2,161 | $ 32,550 | $ 1,700,423 | 5.01 |

Maturities of mortgage-backed securities are based on contractual terms assuming no prepayments. Expected maturities of investments might differ from contractual maturities because they may be subject to prepayments and/or call options. The weighted-average yield on investment securities held for sale is based on amortized cost and, therefore, does not give effect to changes in fair value. The net unrealized gains or losses on available for sale securities are presented as part of accumulated other comprehensive income.

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The following tables show the Corporation s available-for-sale investments fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of June 30, 2007 and December 31, 2006:

| | As of June 30, 2007 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In thousands) | | | | | |
| **Debt securities** | | | | | | |
| Obligations of U.S. Government sponsored agencies | $ | $ | $ 395,877 | $ 18,981 | $ 395,877 | $ 18,981 |
| Puerto Rico Government obligations | 1,316 | 13 | 13,395 | 765 | 14,711 | 778 |
| **Mortgage-backed securities** | | | | | | |
| FHLMC | 87 | | 3,490 | 243 | 3,577 | 243 |
| GNMA | 804 | 10 | 319,459 | 14,742 | 320,263 | 14,752 |
| FNMA | 88,397 | 2,152 | 673,604 | 22,779 | 762,001 | 24,931 |
| Mortgage pass-through trust certificates | 138,096 | 708 | | | 138,096 | 708 |
| **Corporate bonds** | | | 4,938 | 773 | 4,938 | 773 |
| **Equity securities** | 2,154 | 757 | 1,662 | 109 | 3,816 | 866 |
| | $ 230,854 | $ 3,640 | $ 1,412,425 | $ 58,392 | $ 1,643,279 | $ 62,032 |

| | As of December 31, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In thousands) | | | | | |
| **Debt securities** | | | | | | |
| Obligations of U.S. Government sponsored agencies | $ 21,802 | $ 146 | $ 381,790 | $ 11,794 | $ 403,592 | $ 11,940 |
| Puerto Rico Government obligations | | | 13,474 | 686 | 13,474 | 686 |
| **Mortgage-backed securities** | | | | | | |
| FHLMC | 30 | | 3,903 | 110 | 3,933 | 110 |
| GNMA | 354,073 | 7,139 | | | 354,073 | 7,139 |
| FNMA | 376,813 | 4,719 | 465,606 | 7,062 | 842,419 | 11,781 |
| **Corporate bonds** | | | 4,961 | 751 | 4,961 | 751 |
| **Equity securities** | 1,629 | 143 | | | 1,629 | 143 |

| | | | | | |
|---|---|---|---|---|---|
| $ 754,347 | $ 12,147 | $ 869,734 | $ 20,403 | $ 1,624,081 | $ 32,550 |

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The Corporation s investment securities portfolio is comprised principally of (i) mortgage-backed securities issued or guaranteed by FNMA, GNMA or FHLMC and (ii) U.S. Treasury and agencies securities. Thus, payment of a substantial portion of these instruments is either guaranteed or secured by mortgages together with a U.S. government sponsored entity or is backed by the full faith and credit of the U.S. government. Principal and interest on these securities are therefore deemed recoverable. The Corporation s policy is to review its investment portfolio for possible other-than temporary impairment, at least quarterly. As of June 30, 2007, management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments; as a result, the impairments are considered temporary.

For each of the six-month periods ended on June 30 of 2007 and 2006, the Corporation recorded other-than-temporary impairments of approximately $2.9 million, on certain equity securities held in its investment portfolio. Management concluded that the declines in value of the securities were other-than-temporary; as such, the cost basis of these securities was written down to the market value as of the date of the analyses and reflected in earnings as a realized loss.

Total proceeds from the sale of securities available for sale during the six-month period ended June 30, 2007 amounted to approximately $3.1 million (2006 $22.8 million). The Corporation realized gross gains of approximately $0.2 million and approximately $0.9 million in gross realized losses for the first six-months of 2007 (2006 $2.6 million in gross realized gains and approximately $0.2 million in gross realized losses).

**Investment Securities Held to Maturity**

The amortized cost, gross unrealized gains and losses, approximate fair value, weighted-average yield and contractual maturities of investment securities held-to-maturity as of June 30, 2007 and December 31, 2006 were as follows:

| | June 30, 2007 | | | | | December 31, 2006 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Amortized cost | Gross Unrealized gains | Gross Unrealized losses | Fair value | Weighted average yield% | Amortized cost | Gross Unrealized gains | Gross Unrealized losses | Fair value | Weighted average yield% |
| | (Dollars in thousands) | | | | | | | | | |
| U.S. Treasury securities: | | | | | | | | | | |
| Due within 1 year | $ 205,800 | $ 39 | $ 7 | $ 205,832 | 4.90 | $ 158,402 | $ 44 | $ | $ 158,446 | 4.97 |
| Obligations of other U.S. Government sponsored agencies: | | | | | | | | | | |
| Due within 1 year | 10,089 | 1 | | 10,090 | 5.24 | 24,695 | 5 | | 24,700 | 5.25 |
| After 10 years | 2,092,355 | | 68,320 | 2,024,035 | 5.82 | 2,074,943 | | 53,668 | 2,021,275 | 5.83 |
| Puerto Rico Government obligations: | | | | | | | | | | |
| After 5 to 10 years | 17,005 | 269 | 326 | 16,948 | 5.84 | 16,716 | 553 | 115 | 17,154 | 5.84 |
| After 10 years | 15,000 | | 260 | 14,740 | 5.50 | 15,000 | 53 | | 15,053 | 5.50 |
| United States and Puerto Rico | 2,340,249 | 309 | 68,913 | 2,271,645 | 5.73 | 2,289,756 | 655 | 53,783 | 2,236,628 | 5.76 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Government obligations | | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | | |
| FHLMC certificates: | | | | | | | | | | |
| After 5 to 10 years | 13,036 | | 498 | 12,538 | 3.68 | 15,438 | | 577 | 14,861 | 3.61 |
| FNMA certificates: | | | | | | | | | | |
| After 5 to 10 years | 12,320 | | 457 | 11,863 | 3.79 | 14,234 | | 484 | 13,750 | 3.80 |
| After 10 years | 934,016 | 5 | 46,104 | 887,917 | 4.36 | 1,025,703 | 48 | 36,064 | 989,687 | 4.40 |
| Mortgage-backed securities | 959,372 | 5 | 47,059 | 912,318 | 4.34 | 1,055,375 | 48 | 37,125 | 1,018,298 | 4.38 |
| Corporate bonds: | | | | | | | | | | |
| After 10 years | 2,000 | | 77 | 1,923 | 5.80 | 2,000 | 40 | | 2,040 | 5.80 |
| Total investment securities held-to-maturity | $ 3,301,621 | $ 314 | $ 116,049 | $ 3,185,886 | 5.33 | $ 3,347,131 | $ 743 | $ 90,908 | $ 3,256,966 | 5.33 |

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Maturities of mortgage-backed securities are based on contractual terms assuming no prepayments. Expected maturities of investments might differ from contractual maturities because they may be subject to prepayments and/or call options.

The following tables show the Corporation s held-to-maturity investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of June 30, 2007 and December 31, 2006.

| | **As of June 30, 2007** | | | | | |
|---|---|---|---|---|---|---|
| | **Less than 12 months** | | **12 months or more** | | **Total** | |
| | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** |
| | (In thousands) | | | | | |
| **Debt securities** | | | | | | |
| Other U.S. Government sponsored agencies | $ 97,660 | $ 7 | $ 2,024,035 | $ 68,320 | $ 2,121,695 | $ 68,327 |
| Puerto Rico Government obligations | 21,673 | 327 | 3,940 | 259 | 25,613 | 586 |
| **Mortgage-backed securities** | | | | | | |
| FHLMC | | | 12,538 | 498 | 12,538 | 498 |
| FNMA | 23,513 | 1,435 | 872,993 | 45,126 | 896,506 | 46,561 |
| **Corporate bonds** | 1,923 | 77 | | | 1,923 | 77 |
| | $ 144,769 | $ 1,846 | $ 2,913,506 | $ 114,203 | $ 3,058,275 | $ 116,049 |

| | As of December 31, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In thousands) | | | | | |
| **Debt securities** | | | | | | |
| Other U.S. Government sponsored agencies | $ | $ | $ 2,021,275 | $ 53,668 | $ 2,021,275 | $ 53,668 |
| Puerto Rico Government obligations | | | 3,978 | 115 | 3,978 | 115 |
| **Mortgage-backed securities** | | | | | | |
| FHLMC | | | 14,861 | 577 | 14,861 | 577 |
| FNMA | 24,589 | 1,020 | 975,510 | 35,528 | 1,000,099 | 36,548 |
| | $ 24,589 | $ 1,020 | $ 3,015,624 | $ 89,888 | $ 3,040,213 | $ 90,908 |

Held-to-maturity securities in an unrealized loss position as of June 30, 2007 are primarily mortgage-backed securities and U.S. agency securities. The vast majority of them are rated the equivalent of AAA by the major rating agencies. The unrealized losses in the held-to-maturity portfolio as of June 30, 2007 are substantially related to market interest rate fluctuations and not deterioration in the creditworthiness of the issuers; as a result, the impairment is considered temporary.

## 5 OTHER EQUITY SECURITIES

Institutions that are members of the FHLB system are required to maintain a minimum investment in FHLB stock. Such minimum is calculated as a percentage of aggregate outstanding mortgages and an additional investment is required that is calculated as a percentage of total FHLB advances, letters of credit, and the collateralized portion of interest-rate swaps outstanding. The stock is capital stock issued at $100 par value. Both stock and cash dividends may be received on FHLB stock.

As of June 30, 2007 and December 31, 2006, the Corporation had investments in FHLB stock with a book value of $41.8 million and $38.4 million, respectively. The estimated market value of such investments is its redemption value determined by the ultimate recoverability of its par value.

The Corporation has other equity securities that do not have a readily available fair value. The carrying value of such securities as of June 30, 2007 and December 31, 2006 was $1.7 million.

## 6 LOAN PORTFOLIO

The following is a detail of the loan portfolio:

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| | (In thousands) | |
| Residential real estate loans | $ 2,898,667 | $ 2,737,392 |
| Commercial loans: | | |
| Construction loans | 1,459,774 | 1,511,608 |
| Commercial mortgage loans | 1,278,995 | 1,215,040 |
| Commercial loans | 2,813,448 | 2,698,141 |
| Loans to local financial institutions collateralized by real estate mortgages and pass-through trust certificates | 663,931 | 932,013 |
| Commercial loans | 6,216,148 | 6,356,802 |
| Finance leases | 386,267 | 361,631 |
| Consumer loans | 1,721,567 | 1,772,917 |
| Loans receivable | 11,222,649 | 11,228,742 |
| Allowance for loan and lease losses | (165,009) | (158,296) |
| Loans receivable, net | 11,057,640 | 11,070,446 |
| Loans held for sale | 26,030 | 35,238 |
| Total loans | $ 11,083,670 | $ 11,105,684 |

The Corporation s primary lending area is Puerto Rico. The Corporation s Puerto Rico banking subsidiary ( First Bank or the Bank ) also lends in the U.S. and British Virgin Islands markets and in the United States (principally in the state of Florida). Of the total gross loan portfolio of $11.2 billion as of June 30, 2007, approximately 79% have credit risk concentration in Puerto Rico, 13% in the United States and 8% in the Virgin Islands.

In February 2007, the Corporation entered into various agreements with R&G Financial Corporation ( R&G Financial ) relating to prior transactions accounted for as commercial loans secured by mortgage loans and pass-through trust certificates from R&G Financial subsidiaries. First, through a mortgage payment agreement, R&G Financial paid the Corporation approximately $50 million to reduce the commercial loan that R&G Premier Bank, R&G Financial's Puerto Rico banking subsidiary, had outstanding with the Corporation.

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In addition, the remaining balance of approximately $271 million was re-documented as a secured loan from the Corporation to R&G Financial. Second, R&G Financial and the Corporation amended various agreements involving, as of the date of the transaction, approximately $183.8 million of securities collateralized by loans that were originally sold through five grantor trusts. The modifications to the original agreements allowed the Corporation to treat these transactions as true sales for accounting and legal purposes and the recharacterization of certain secured commercial loans as securities collateralized by loans. The agreements enabled the Corporation to fulfill the remaining requirement of the consent order signed with banking regulators relating to the mortgage-related transactions with R&G Financial that First BanCorp accounted for as commercial loans secured the mortgage loans and pass-through trust certificates.

As part of the agreements entered with R&G Financial, the Corporation recognized a net gain of $2.5 million in the first quarter of 2007 as a result of the differential between the carrying value of the loans, the net payment received and the fair value of securities obtained from R&G Financial.

**7 ALLOWANCE FOR LOAN AND LEASE LOSSES**

The changes in the allowance for loan and lease losses were as follows:

| | Quarter Ended June 30, | | Six-Month Period Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (In thousands) | | | |
| Balance at beginning of period | $ 161,419 | $ 152,596 | $ 158,296 | $ 147,999 |
| Provision for loan and lease losses | 24,628 | 9,354 | 49,542 | 28,730 |
| Charge-offs | (22,419) | (16,812) | (45,596) | (33,261) |
| Recoveries | 1,381 | 1,389 | 2,767 | 3,059 |
| Balance at end of period | $ 165,009 | $ 146,527 | $ 165,009 | $ 146,527 |

The allowance for impaired loans is part of the allowance for loan and lease losses. The allowance is for loans with respect to which management has determined that it is probable that the debtor will be unable to pay all the amounts due, according to the contractual terms of the loan agreement, and do not necessarily represent loans for which the Corporation will incur a substantial loss. As of June 30, 2007 and December 31, 2006, impaired loans had a related allowance as follows:

| | As of June 30, 2007 | As of December 31, 2006 |
|---|---|---|
| | (In thousands) | |
| Impaired loans | $ 153,579 | $ 63,022 |
| Allowance for impaired loans | 9,761 | 9,989 |

Interest income in the amount of approximately $1.1 million and $0.8 million was recognized on impaired loans for the quarters ended June 30, 2007 and 2006, respectively. Interest income in the amount of approximately $1.9 million and $2.0 million was recognized on impaired loans for the six-month period ended June 30, 2007 and 2006, respectively.

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## 8 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The primary market risk facing the Corporation is interest rate risk, which includes the risk that changes in interest rates will result in changes in the value of its assets or liabilities and the risk that net interest income from its loan and investment portfolios will change in response to changes in interest rates. The overall objective of the Corporation s interest rate risk management activities is to reduce the variability of earnings caused by changes in interest rates.

The Corporation uses various financial instruments, including derivatives, to manage the interest rate risk related primarily to the values of its brokered CDs and medium-term notes.

The Corporation designates a derivative as either a fair value hedge, cash flow hedge or as an economic undesignated hedge when it enters into the derivative contract. As part of the interest rate risk management, the Corporation has entered into a series of interest rate swap agreements. Under the interest rate swaps, the Corporation agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Net interest settlements on interest rate swaps and unrealized gains and losses arising from changes in fair value are recorded as an adjustment to interest income or interest expense depending on whether an asset or liability is being hedged. As of June 30, 2007, all derivatives held by the Corporation were considered economic undesignated hedges.

Effective January 1, 2007, the Corporation adopted SFAS 159 for its callable brokered CDs and a portion of its callable fixed medium-term notes that were hedged with interest rate swaps, following fair value hedge accounting under SFAS 133. Interest rate risk on the callable brokered CDs and medium-term notes elected for the fair value option under SFAS 159 continues to be economically hedged with callable interest rate swaps. Prior to the implementation of SFAS 159, the Corporation had been following the long-haul method of accounting under SFAS 133, which was adopted on April 3, 2006, for its portfolio of callable interest rate swaps, callable brokered CDs and callable notes. The long-haul method requires periodic assessment of hedge effectiveness and measurement of ineffectiveness. The ineffectiveness results to the extent that changes in the fair value of a derivative do not offset changes in the fair value of the hedged item. The Corporation recognized, as a reduction to interest expense, approximately $2.0 million for the quarter ended June 30, 2006, representing ineffectiveness on derivatives that qualified as a fair value hedge under SFAS 133.

In addition, effective on January 1, 2007, the Corporation discontinued the use of fair value hedge accounting under SFAS 133 for interest rate swaps that hedge its $150 million medium-term note ( the $150 million medium-term note ). The Corporation s decision was based on the determination that the interest rate swaps were no longer effective in offsetting the changes in the fair value of the $150 million medium-term note. After the discontinuance of hedge accounting, the basis adjustment, which represents the basis differential between the market value and the book value of the $150 million medium-term note recognized at the inception of fair value hedge accounting on April 3, 2006, as well as changes in fair value recognized after the inception until the discontinuance of fair value hedge accounting on January 1, 2007, is being amortized or accreted over the remaining life of the liability as a yield adjustment. The $150 million medium-term note was redeemed prior to its maturity during the second quarter of 2007.

The following table summarizes the notional amounts of all derivative instruments as of June 30, 2007 and December 31, 2006:

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| | Notional amounts | |
|---|---|---|
| | As of June 30, 2007 | As of December 31, 2006 |
| | (In thousands) | |
| Interest rate swap agreements: | | |
| Pay fixed versus receive floating | $ 80,572 | $ 80,720 |
| Receive fixed versus pay floating | 4,610,951 | 4,802,370 |
| Embedded written options | 53,515 | 13,515 |
| Purchased options | 53,515 | 13,515 |
| Written interest rate cap agreements | 128,090 | 125,200 |
| Purchased interest rate cap agreements | 307,879 | 330,607 |
| | $ 5,234,522 | $ 5,365,927 |

The following table summarizes the notional amounts of all derivatives by the Corporation s designation as of June 30, 2007 and December 31, 2006:

| | Notional amounts | |
|---|---|---|
| | As of June 30, 2007 | As of December 31, 2006 |
| | (In thousands) | |
| Economic undesignated hedges: | | |
| Interest rate swaps used to hedge fixed rate certificates of deposit, notes payable and loans | $ 4,691,523 | $ 336,473 |
| Embedded options on stock index deposits | 53,515 | 13,515 |
| Purchased options used to manage exposure to the stock market on embedded stock index options | 53,515 | 13,515 |
| Written interest rate cap agreements | 128,090 | 125,200 |
| Purchased interest rate cap agreements | 307,879 | 330,607 |
| Total derivatives not designated as hedges | $ 5,234,522 | $ 819,310 |
| Designated hedges: | | |
| Fair value hedges: | | |
| Interest rate swaps used to hedge fixed-rate certificates of deposit | $ | $ 4,381,175 |
| Interest rate swaps used to hedge fixed- and step-rate notes payable | | 165,442 |
| Total fair value hedges | $ | $ 4,546,617 |
| Total | $ 5,234,522 | $ 5,365,927 |

As of June 30, 2007, derivatives not designated or not qualifying for hedge accounting with a positive fair value of $28.0 million (December 31, 2006 $16.2 million) and a negative fair value of $207.2 million (December 31, 2006

$16.3 million) were recorded as part of Other Assets and Accounts payable and other liabilities, respectively, in the Consolidated Statements of Financial Condition. As of December 31, 2006 derivatives qualifying for fair value hedge accounting with a negative fair value of $126.7 million were recorded as part of Accounts payable and other liabilities in the Consolidated Statement of Financial Condition.

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The majority of the Corporation s derivative instruments represent interest rate swaps that mainly convert long-term fixed-rate brokered CDs to a floating-rate. A summary of the types of swaps used as of June 30, 2007 and December 31, 2006 follows:

| | As of June 30, 2007 | As of December 31, 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| Pay fixed/receive floating (generally used to economically hedge variable rate loans): | | |
| Notional amount | $ 80,572 | $ 80,720 |
| Weighted average receive rate at period end | 7.01% | 7.38% |
| Weighted average pay rate at period end | 6.53% | 6.37% |
| Floating rates range from 167 to 252 basis points over 3-month LIBOR | | |
| Receive fixed/pay floating (generally used to economically hedge fixed-rate brokered CDs and notes payable): | | |
| Notional amount | $4,610,951 | $4,802,370 |
| Weighted average receive rate at period end | 5.19% | 5.16% |
| Weighted average pay rate at period end | 5.40% | 5.42% |
| Floating rates range from 5 basis points under to 11 basis points over 3-month LIBOR | | |

Indexed options are generally over-the-counter (OTC) contracts that the Corporation enters into in order to receive the appreciation of a specified Stock Index (e.g., Dow Jones Industrial Composite Stock Index) over a specified period in exchange for a premium paid at the contract s inception. The option period is determined by the contractual maturity of the notes payable tied to the performance of the Stock Index. The credit risk inherent in these options is the risk that the exchange party may not fulfill its obligation.

Interest rate caps are option-like contracts that require the writer, i.e., the seller, to pay the purchaser at specified future dates the amount, if any, by which a specified market interest rate exceeds the fixed cap rate, applied to a notional principal amount.

To satisfy the needs of its customers, the Corporation may enter into non-hedging transactions. On these transactions, generally, the Corporation participates as a buyer in one of the agreements and as the seller in the other agreement under the same terms and conditions.

In addition, the Corporation enters into certain contracts with embedded derivatives that do not require separate accounting as these are clearly and closely related to the economic characteristics of the host contract. When the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract, it is bifurcated, carried at fair value, and designated as a trading or non-hedging derivative instrument.

## 9 GOODWILL AND OTHER INTANGIBLES

Goodwill as of June 30, 2007 amounted to $28.1 million (December 31, 2006 $28.7 million), recognized as part of Other Assets , resulting primarily from the acquisition of Ponce General Corporation in 2005. No goodwill impairment was recognized during 2007 and 2006.

As of June 30, 2007, the gross carrying amount and accumulated amortization of core deposit intangibles was $41.2 million and $16.6 million, respectively, recognized as part of Other Assets in the Consolidated Statements of Financial Condition (December 31, 2006 $41.2 million and $15.0 million, respectively). For each of the quarters ended June 30, 2007 and 2006, the amortization expense of core deposits amounted to $0.8 million. For the six-month periods ended June 30, 2007 and 2006, the amortization expense of core deposits amounted to $1.7 million and $1.8 million, respectively.

## 10 DEPOSITS

The following table summarizes deposit balances:

| | As of June 30, 2007 | As of December 31, 2006 |
|---|---|---|
| | (In thousands) | |
| Non-interest bearing checking account deposits | $ 642,834 | $ 790,985 |
| Savings accounts | 1,042,172 | 984,332 |
| Interest-bearing checking accounts | 473,370 | 433,278 |
| Certificates of deposit | 1,659,608 | 1,696,213 |
| Brokered certificates of deposit (includes $4,316,392 measured at fair value as of June 30, 2007) | 7,814,947 | 7,099,479 |
| | $ 11,632,931 | $ 11,004,287 |

The interest expense on deposits includes the valuation to market of interest rate swaps that hedge brokered CDs (economically or under fair value hedge accounting), the related interest exchanged, the amortization of broker placement fees, the amortization of basis adjustment and changes in fair value of callable brokered CDs elected for the fair value option under SFAS 159 ( SFAS 159 brokered CDs ).

The following are the components of interest expense on deposits:

| | Quarter ended | | Six-month period ended | |
|---|---|---|---|---|
| | June 30, 2007 | June 30, 2006 | June 30, 2007 | June 30, 2006 |
| | (In thousands) | | | |
| Interest expense on deposits | $ 125,690 | $ 143,801 | $ 248,054 | $ 261,053 |
| Amortization of broker placement fees (1) | 2,114 | 4,756 | 4,258 | 8,705 |
| Interest expense on deposits excluding net unrealized loss on derivatives (undesignated and designated hedges), SFAS 159 brokered CDs and amortization of basis adjustment on fair value hedges | 127,804 | 148,557 | 252,312 | 269,758 |
| Net unrealized loss on derivatives (undesignated and designated hedges) and SFAS 159 brokered CDs | 6,078 | 7,318 | 5,660 | 72,955 |
| Amortization of basis adjustment on fair value hedges | | 1,279 | | 1,279 |
| Total interest expense on deposits | $ 133,882 | $ 157,154 | $ 257,972 | $ 343,992 |

(1) For 2007 the amortization of broker placement fees is related to brokered CDs not elected for the fair value option under SFAS 159.

Total interest expense on deposits includes interest exchanged on interest rate swaps that hedge (economically or under fair value hedge accounting) brokered CDs that for the quarter and six-month period ended June 30, 2007 amounted to net interest incurred of $3.5 million and of $7.3 million, respectively (2006 -

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net interest incurred of $1.8 million for the second quarter and net interest realized of $1.7 million for the six- month period).

**11 NOTES PAYABLE**

Notes payable consist of:

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| | (In thousands) | |
| Callable fixed-rate notes, bearing interest at 6.00%, maturing on October 1, 2024 (1) | $ | $ 151,554 |
| Callable step-rate notes, bearing step increasing interest from 5.00% to 7.00% maturing on October 18, 2019, measured at fair value under SFAS 159 as of June 30, 2007 | 14,666 | 15,616 |
| Dow Jones Industrial Average (DJIA) linked principal protected notes: | | |
| Series A maturing on February 28, 2012 | 8,473 | 7,525 |
| Series B maturing on May 27, 2011 | 9,077 | 8,133 |
| | $ 32,216 | $ 182,828 |

(1) During the second quarter of 2007, the Corporation early redeemed the $150 million medium-term note. The derecognition of the unamortized balances of the basis adjustment, placement fees and debt issue costs resulted in adjustments to earnings of approximately $1.3 million, increasing the Corporation s net interest income.

**12 OTHER BORROWINGS**

Other borrowings consist of:

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| | (In thousands) | |
| Junior subordinated debentures due in 2034, interest-bearing at a floating-rate of 2.75% over 3-month LIBOR (8.11% as of June 30, 2007 and as of December 31, 2006) | $ 102,902 | $ 102,853 |
| Junior subordinated debentures due in 2034, interest-bearing at a floating-rate of 2.50% over 3-month LIBOR (7.86% as of June 30, 2007 7.87% as of December 31, 2006) | 128,866 | 128,866 |
| | $ 231,768 | $ 231,719 |

## 13 INCOME TAXES

Income tax expense includes Puerto Rico and Virgin Islands income taxes as well as applicable U.S. federal and state taxes. The Corporation is subject to Puerto Rico income tax on its income from all sources. As a Puerto Rico corporation, First BanCorp is treated as a foreign corporation for U.S. income tax purposes and is generally subject to United States income tax only on its income from sources within the United States or income effectively connected with the conduct of a trade or business within the United States. Any such tax paid is creditable, within certain conditions and limitations, against the Corporation s Puerto Rico tax liability. The Corporation is also subject to U.S.Virgin Islands taxes on its income from sources within this jurisdiction. Any such tax paid is creditable against the Corporation s Puerto Rico tax liability, subject to certain conditions and limitations.

Under the Puerto Rico Internal Revenue Code of 1994, as amended ( PR Code ), First BanCorp is subject to a maximum statutory tax rate of 39%, except that in years 2005 and 2006, an additional transitory tax rate of 2.5% was signed into law by the Governor of Puerto Rico. In August 2005, the Government of Puerto Rico approved a transitory tax rate of 2.5% that increased the maximum statutory tax rate from 39.0% to 41.5% for a two-year period. On May 13, 2006, with an effective date of January 1, 2006, the Governor of Puerto Rico approved an additional transitory tax rate of 2.0% applicable only to companies covered by the Puerto Rico Banking Act as amended, such as First Bank, which raised the maximum statutory tax rate to 43.5% for taxable years that commenced during calendar year 2006. For taxable years beginning after December 31, 2006, the maximum statutory tax rate is 39%. The PR Code also includes an alternative minimum tax of 22% that applies if the Corporation s regular income tax liability is less than the alternative minimum tax requirements.

The Corporation has maintained an effective tax rate lower than the maximum statutory rate mainly by investing in government obligations and mortgage-backed securities exempt from U.S. and Puerto Rico income taxes and doing business through international banking entities ( IBEs ) of the Corporation and the Bank and through the Bank s subsidiary, FirstBank Overseas Corporation, in which the interest income and gain on sales is exempt from Puerto Rico and U.S. income taxation. The IBEs and FirstBank Overseas Corporation were created under the International Banking Entity Act of Puerto Rico, which provides for total Puerto Rico tax exemption on net income derived by IBEs operating in Puerto Rico. Since 2004, IBEs that operate as a unit of a bank pay income taxes at normal rates to the extent that the IBEs net income exceeds predetermined percentages of the bank s total net taxable income; this percentage is 20% of total net taxable income for taxable years commencing after July 1, 2005.

For the six-month period ended June 30, 2007, the Corporation recognized an income tax expense of $12.4 million, compared to $4.3 million for the same period in 2006. The increase in income tax expense for the first half of 2007 as compared to the first half of 2006 was mainly due to a decrease in deferred income tax benefits, resulting from lower unrealized losses on derivative instruments and the adoption of SFAS 159, partially offset by a reduction in the current income tax provision.

The adoption of the long-haul method of effectiveness testing under SFAS 133, on April 3, 2006, caused significant fluctuations in operating results when comparing year to date figures for 2007 and 2006. Prior to the implementation of the long-haul method, the Corporation recorded as part of interest expense unrealized losses of $69.7 million in the valuation of derivative instruments during the first quarter of 2006, which resulted on higher deferred tax benefits. The adoption of the long-haul method during the second quarter of 2006 and SFAS 159 effective January 1, 2007, reduced the earnings volatility that previously resulted from the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. For the first half of 2007, the Corporation recorded net unrealized and realized losses on derivative instruments and SFAS 159 liabilities of $6.9 million compared to net unrealized losses of $77.3 million for the same period in 2006. For the first half of 2007, the Corporation recognized a deferred tax benefit of $2.0 million compared to $26.5 million for the same period in 2006.

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The current provision for income taxes for the first half of 2007 amounted to $14.4 million compared to $30.6 million for the first half of 2006, a decrease of $16.2 million. The decrease in the current income tax provision for the first half of 2007 is mainly attributable to a lower taxable income.

As of June 30, 2007, the Corporation evaluated its ability to realize the deferred tax asset and concluded, based on the evidence available, that it is more likely than not that some of the deferred tax asset will not be realized and thus, established a valuation allowance of $6.2 million, compared to a valuation allowance of $6.1 million as of December 31, 2006. As of June 30, 2007, the deferred tax asset, net of the valuation allowance of $6.2 million, amounted to approximately $110.1 million compared to $162.1 million as of December 31, 2006.

The Corporation adopted FIN 48 as of January 1, 2007. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of income tax uncertainties with respect to positions taken or expected to be taken in income tax returns. The adoption of FIN 48 reduced the beginning balance of retained earnings as of January 1, 2007 by $2.6 million. Under FIN 48, income tax benefits are recognized and measured based upon a two-step model: 1) a tax position must be more likely than not to be sustained based solely on its technical merits in order to be recognized, and 2) the benefit is measured as the largest dollar amount of that position that is more likely than not to be sustained upon settlement. The difference between the benefit recognized in accordance with FIN 48 and the tax benefit claimed on a tax return is referred to as an unrecognized tax benefit ( UTB ).

As of January 1, 2007, the balance of the Corporation s UTBs, amounted to $28.5 million, all of which would, if recognized, affect the Corporation s effective tax rate. The Corporation classifies all interest and penalties, if any, related to tax uncertainties as income tax expense. As of January 1, 2007, the Corporation s accrual for interest that relate to tax uncertainties amounted to $6.3 million. As of January 1, 2007 there is no need to accrue for the payment of penalties. The amount of UTBs may increase or decrease in the future for various reasons, including changes in the amounts for current tax year positions, expiration of open income tax returns due to the statutes of limitations, changes in management s judgment about the level of uncertainty, status of examinations, litigation and legislative activity and the addition or elimination of uncertain tax positions. The Corporation does not anticipate any significant changes to its UTBs within the next 12 months.

The Corporation s liability for income taxes includes the liability for UTBs, and interest which relate to tax years still subject to review by taxing authorities. Audit periods remain open for review until the statute of limitations has passed. The statute of limitations under the PR Code is 4 years; and for the Virgin Islands and U.S. income tax purposes is 3 years after a tax return is due or filed, whichever is later. The completion of an audit by the taxing authorities or the expiration of the statute of limitations for a given audit period could result in an adjustment to the Corporation s liability for income taxes. Any such adjustment could be material to results of operations for any given quarterly or annual period based, in part, upon the results of operations for the given period.

**14 FAIR VALUE**

As discussed in Note 1 Basis of Presentation and Significant Accounting Policies , effective January 1, 2007, the Corporation adopted SFAS 157, which provides a framework for measuring fair value under GAAP.

The Corporation also adopted SFAS 159 effective January 1, 2007. SFAS 159 generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. The Corporation elected to adopt the fair value option for certain of its brokered CDs and medium-term notes on the adoption date. SFAS 159 requires that the difference between the carrying value before the election of the fair value option and the fair value of these instruments be recorded as an adjustment to beginning retained earnings in the period of adoption.

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The following table summarizes the impact of adopting the fair value option for certain brokered CDs and medium-term notes on January 1, 2007. Amounts shown represent the carrying value of the affected instruments before and after the changes in accounting resulting from the adoption of SFAS 159.

***Transition Impact***

| (In thousands) | Ending Statement of Financial Condition as of December 31, 2006 (Prior to Adoption) (1) | Net Increase in Retained Earnings upon Adoption | Opening Statement of Financial Condition as of January 1, 2007 (After Adoption of Fair Value Option) |
|---|---|---|---|
| Callable brokered CDs | $ (4,513,020) | $ 149,621 | $ (4,363,399) |
| Medium-term notes | (15,637) | 840 | $ (14,797) |
| Cumulative-effect adjustment (pre-tax) | | 150,461 | |
| Tax impact | | (58,683) | |
| Cumulative-effect adjustment (net of tax), increase to retained earnings | | $ 91,778 | |

(1) Net of debt issue costs, placement fees and basis adjustment as of December 31, 2006.

***Fair Value Option***

**Callable brokered CDs and Certain Medium-Term Notes**

The Corporation elected to account at fair value certain financial liabilities which were hedged with interest rate swaps which were designated for fair value hedge accounting in accordance with SFAS 133. As of June 30, 2007, these liabilities included callable brokered CDs with an aggregate fair value of $4.3 billion and principal balance of $4.5 billion recorded in interest-bearing deposits; and certain medium-term notes with a fair value of $14.7 million and principal balance of $15.4 million recorded in notes payable. Interest paid on these instruments continues to be recorded in interest expense and the accrued interest is part of the fair value of the SFAS 159 liabilities. Electing the fair value option allows the Corporation to eliminate the burden of complying with the requirements for hedge accounting under SFAS 133 (e.g., documentation and effectiveness assessment) without introducing earnings volatility. Interest rate risk on the callable brokered CDs and medium-term notes measured at fair value under SFAS 159 continue to be economically hedged with callable interest rate swaps with the same terms and conditions. The Corporation did not elect the fair value option for other brokered CDs and the other callable medium-term note, the $150 million medium-term note, because these are not hedged by derivatives that qualified for hedge accounting in accordance with SFAS 133. Effective January 1, 2007, the Corporation discontinued the use of fair value hedge accounting for interest rate swaps that hedge the $150 million medium-term note since the interest rate swaps were not longer effective in offsetting the changes in the fair value of the $150 million medium-term note. The Corporation redeemed the $150 million medium-term note during the second quarter of 2007.

Callable brokered CDs and medium-term notes for which the Corporation has elected the fair value option are priced by valuation experts using observable market data in the institutional markets.

***Fair Value Measurement***

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

**Level 1** Level assets and liabilities include equity securities that are traded in an active exchange market, as well as certain U.S. Treasury and other U.S. government and agency securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

**Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include (i) mortgage-backed securities for which the fair value is estimated based on valuations obtained from third-party pricing services for identical or comparable assets, (ii) debt securities with quoted prices that are traded less frequently than exchange-traded instruments and (iii) derivative contracts and financial liabilities (e.g. callable brokered CDs and medium-term notes elected for fair value option under SFAS 159) whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

**Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models for which the determination of fair value requires significant management judgment or estimation.

The following is a description of the valuation methodologies used for instruments measured at fair value:

***Callable Brokered CDs***

The fair value of brokered CDs, included within deposits, is determined using discounted cash flow analyses over the full term of the CDs. The valuation uses a Hull-White Interest Rate Tree approach for the CDs with callable option components, an industry-standard approach for valuing instruments with interest rate call options. The model assumes that the embedded options are exercised economically. The fair value of the CDs is computed using the outstanding principal amount. The discount rates used are based on US dollar LIBOR and swap rates. At-the-money implied swaption volatility term structure (volatility by time to maturity) is used to calibrate the model to current market prices and value the cancellation option in the deposits. Effective January 1, 2007, the Corporation updated its methodology to calculate the impact of its own credit standing.

***Medium-Term Notes***

The fair value of term notes is determined using a discounted cash flow analysis over the full term of the borrowings. This valuation also uses the Hull-White Interest Rate Tree approach to value the option components of the term notes. The model assumes that the embedded options are exercised economically. The fair value of medium-term notes is computed using the notional amount outstanding. The discount rates used in the valuations are based on US dollar LIBOR and swap rates. At-the-money implied swaption volatility term structure (volatility by time to maturity) is used to calibrate the model to current market prices and value the cancellation option in the term notes. Effective January 1, 2007, the Corporation updated its methodology to calculate the impact of its own credit standing. The net gain from fair value changes attributable to the Corporation s own credit to the medium-term notes that the Corporation has elected the fair value option amounted to $1.0 million for the six-month period ended June 30, 2007. For the medium-term notes the credit risk is measured using the difference in yield curves between Swap rates and Treasury rates at a tenor comparable to the time to maturity of the note and option.

***Investment Securities***

The fair value of investment securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers. If listed prices or quotes are not available,

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fair value is based upon externally developed models that use unobservable inputs due to the limited market activity of the instrument.

***Derivative Instruments***

The fair value of the derivative instruments was provided by valuation experts and counterparties. Certain derivatives with limited market activity are valued using externally developed models that consider unobservable market parameters.

Assets and liabilities measured at fair value on a recurring basis, including financial liabilities for which the Corporation has elected the fair value option, are summarized below:

| | June 30, 2007 Fair Value Measurements Using | | | |
|---|---|---|---|---|
| *(In thousands)* | **Level 1** | **Level 2** | **Level 3** | **Assets/ (Liabilities) at Fair Value** |
| Callable brokered CDs (1) | $ | $(4,316,392) | $ | $ (4,316,392) |
| Medium-term notes (1) | | (14,666) | | (14,666) |
| Securities available for sale (2) | 405,636 | 1,155,490 | 171,988 | 1,733,114 |
| Derivative instruments (3) | | (193,823) | 14,633 | (179,190) |

(1) Amounts represented items for which the Corporation had elected the fair value option under SFAS 159.

(2) Carried at fair value prior to the adoption of SFAS 159.

(3) Derivatives as of June 30, 2007 included derivative assets of $28.0 million and derivative liabilities of $207.2 million, all of which were carried at fair value prior to the adoption of SFAS 159.

| Changes in Fair Values for the Quarter Ended | Changes in Fair Values for the Six-Month Period Ended |
|---|---|

| | June 30, 2007, for items Measured at Fair Value Pursuant to Election of the Fair Value Option | | | June 30, 2007, for items Measured at Fair Value Pursuant to Election of the Fair Value Option | | |
|---|---|---|---|---|---|---|
| | Gains included in Interest Expense on Deposits | Gains included in Interest Expense on Notes Payable | Total Changes in Fair Value Gains Included in Current-Period Earnings (1) | Losses included in Interest Expense on Deposits | Losses included in Interest Expense on Notes Payable | Total Changes in Fair Value Included in Losses Current-Period Earnings (1) |
| Callable brokered CDs | $ 18,813 | $ | $ 18,813 | $ (56,364) | $ | $ (56,364) |
| Medium-term notes | | 59 | 59 | | (256) | (256) |
| | $ 18,813 | $ 59 | $ 18,872 | $ (56,364) | $ (256) | $ (56,620) |

(1) Changes in fair value for the quarter and six-month period ended June 30, 2007 include interest expense on callable brokered CDs of $56.8 million and $112.8 million, respectively, and interest expense on medium-term notes of $0.2 million and $0.4 million, respectively. Interest expense on callable brokered CDs and medium-term notes that have

been elected to be carried at fair value under the provisions of SFAS 159 are recorded in interest expense in the Consolidated Statements of Income based on their contractual coupons.

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The table below presents a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the quarter and six-month period ended June 30, 2007.

| **Level 3 Instruments Only** | **Total Fair Value Measurements ( Quarter ended June 30, 2007)** | | **Total Fair Value Measurements ( Six-month period ended June 30, 2007)** | |
|---|---|---|---|---|
| *(In thousands)* | **Derivatives (1)** | **Securities Available For Sale (2)** | **Derivatives (1)** | **Securities Available For Sale (2)** |
| Beginning balance | $ 9,583 | $ 176,786 | $ 10,288 | $ 370 |
| Total gains or (losses) (realized/unrealized): | | | | |
| Included in earnings | 5,050 | | 4,345 | |
| Included in other comprehensive income | | 2,956 | | (535) |
| New instruments acquired | | | | 182,376 |
| Principal repayments and amortization | | (7,754) | | (10,223) |
| Transfers in and/or out of Level 3 | | | | |
| Ending balance | $ 14,633 | $ 171,988 | $ 14,633 | $ 171,988 |

(1) Amounts mostly related to the valuation of interest rate cap agreements which were carried at fair value prior to the adoption of SFAS 159.

(2) Amounts mostly related to certain available for sale securities collateralized by loans acquired in the first quarter of 2007 as part of the recharacterization of certain secured commercial loans.

The table below summarizes gains and losses due to changes in fair value recorded in earnings for Level 3 assets and liabilities for the quarter and six-month period ended June 30, 2007.

| **Level 3 Instruments Only** | **Total Gains and (Losses) (Quarter ended June 30, 2007)** | **Total Gains and (Losses) (Six-month period ended June** |
|---|---|---|

| | | 30, 2007) | | |
|---|---|---|---|---|
| *(In thousands)* | **Derivatives (1)** | **Securities Available For Sale** | **Derivatives (1)** | **Securities Available For Sale** |
| **Classification of gains and (losses) included in earnings (2):** | | | | |
| Interest income on loans | $ 159 | $ | $ (136) | $ |
| Interest income on investment securities | 4,891 | | 4,481 | |
| | $ 5,050 | $ | $ 4,345 | $ |

(1) Amount represents valuation of interest rate cap agreements which were carried at fair value prior to the adoption of SFAS 159.

(2) All gains and losses included in current period earnings were unrealized.

The table below summarizes changes in unrealized gains or losses recorded in earnings for the quarter and six-month period ended June 30, 2007 for Level 3 assets and liabilities that are still held as of June 30, 2007.

| **Level 3 Instruments Only** | **Changes in Unrealized Gains and (Losses) (Quarter ended June 30, 2007)** | | **Changes in Unrealized Gains and (Losses) (Six-month period ended June 30, 2007)** | |
|---|---|---|---|---|
| *(In thousands)* | **Derivatives (1)** | **Securities Available For Sale** | **Derivatives (1)** | **Securities Available For Sale** |
| **Changes in unrealized gains and (losses) relating to assets still held at reporting date:** | | | | |
| Interest income on loans | $ 159 | $ | $ (136) | $ |
| Interest income on investment securities | 4,891 | | 4,481 | |
| | $ 5,050 | $ | $ 4,345 | $ |

(1) Amount represents

valuation of interest rate cap agreements which were carried at fair value prior to the adoption of SFAS 159.

Additionally, fair value is used on a non-recurring basis to evaluate certain assets in accordance with GAAP. Adjustments to fair value usually result from the application of lower-of-cost-or market accounting (e.g., loans held for sale carried at the lower of cost or fair value and repossessed assets) or write-downs of individual assets (e.g., goodwill). As of June 30, 2007, loans held for sale carried at the lower of cost or fair value, with an aggregate cost of $26.4 million had been written down to fair value of $26.0 million. Fair value of loans held for sale is primarily derived from independent market quotations based on the mortgage-backed securities market (Level 2).

**15 SEGMENT INFORMATION**

Based upon the Corporation s organizational structure and the information provided to the Chief Operating Decision Maker and to a lesser extent to the Board of Directors, the operating segments are driven primarily by the Corporation s legal entities. As of June 30, 2007, the Corporation had four reportable segments: Commercial and Corporate Banking; Mortgage Banking; Consumer (Retail) Banking; and Treasury and Investments, as well as an Other category reflecting other legal entities reported separately on an aggregate basis. Management determined the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. Other factors such as the Corporation s organizational chart, nature of the products, distribution channels and the economic characteristics of the products were also considered in the determination of the reportable segments.

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The Commercial and Corporate Banking segment consists of the Corporation s lending and other services for large customers represented by the public sector and specialized and middle-market clients. The Commercial and Corporate Banking segment offers commercial loans, including commercial real estate and construction loans, and other products such as cash management and business management services. The Mortgage Banking segment s operations consist of the origination, sale and servicing of a variety of residential mortgage loans. The Mortgage Banking segment also acquires and sells mortgages in the secondary markets. In addition, the Mortgage Banking segment includes mortgage loans purchased from other local banks or mortgage bankers. The Consumer (Retail) segment consists of the Corporation s consumer lending and deposit-taking activities conducted mainly through its branch network and loan centers. The Treasury and Investment segment is responsible for the Corporation s investment portfolio and treasury functions executed to manage and enhance liquidity. This segment loans funds to the Commercial and Corporate Banking; Mortgage Banking; and Consumer segments to finance their lending activities and borrows from those segments. The Consumer segment also loans funds to other segments. The interest rates charged or credited by Treasury and Investments and the Consumer segments are allocated based on market rates. The difference between the allocated interest income or expense and the Corporation s actual net interest income from centralized management of funding costs is reported in the Treasury and Investments segment. The Other category is mainly composed of insurance, finance leases and other products.

The accounting policies of the business segments are the same as those described in Note 1 of the Corporation s financial statements for the year ended December 31, 2006 contained in the Corporation s annual report on Form 10-K.

The Corporation evaluates the performance of the segments based on net interest income after the estimated provision for loan and lease losses, non-interest income and direct non-interest expenses. The segments are also evaluated based on the average volume of their interest-earning assets less the allowance for loan and lease losses. The following table presents information about the reportable segments (in thousands):

| | Mortgage Banking | Consumer | Commercial and Corporate | Treasury and Investments | Other | Total |
|---|---|---|---|---|---|---|
| **For the quarter ended June 30, 2007:** | | | | | | |
| Interest income | $ 40,944 | $ 46,506 | $ 109,183 | $ 76,148 | $ 33,090 | $ 305,871 |
| Net (charge) credit for transfer of funds | (30,933) | 26,202 | (72,460) | 81,750 | (4,559) | |
| Interest expense | | (19,921) | | (160,598) | (8,137) | (188,656) |
| Net interest income (loss) | 10,011 | 52,787 | 36,723 | (2,700) | 20,394 | 117,215 |
| Provision for loan and lease losses | (1,237) | (12,091) | (8,171) | | (3,129) | (24,628) |
| Other income (loss) | 372 | 6,275 | 1,272 | (1,297) | 4,281 | 10,903 |
| Direct operating expenses | (5,114) | (22,707) | (3,658) | (2,023) | (11,230) | (44,732) |
| Segment income (loss) | $ 4,032 | $ 24,264 | $ 26,166 | $ (6,020) | $ 10,316 | $ 58,758 |
| Average earnings assets | $ 2,527,577 | $ 1,835,842 | $ 5,401,162 | $ 5,369,401 | $ 1,307,741 | $ 16,441,723 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **For the quarter ended June 30, 2006:** | | | | | | |
| Interest income | $ 36,528 | $ 50,539 | $ 132,974 | $ 96,218 | $ 28,184 | $ 344,443 |
| Net (charge) credit for transfer of funds | (26,269) | 28,134 | (87,038) | 90,114 | (4,941) | |
| Interest expense | | (17,902) | | (194,388) | (5,915) | (218,205) |
| Net interest income (loss) | 10,259 | 60,771 | 45,936 | (8,056) | 17,328 | 126,238 |
| (Provision) recovery for loan and lease losses | (3,261) | 368 | 865 | | (7,326) | (9,354) |
| Other income | 450 | 5,909 | 2,127 | 64 | 4,873 | 13,423 |
| Net loss on partial extinguishment of a secured commercial loan to a local financial institution | | | (11,640) | | | (11,640) |
| Direct operating expenses | (3,790) | (21,259) | (3,323) | (1,425) | (11,170) | (40,967) |
| Segment income (loss) | $ 3,658 | $ 45,789 | $ 33,965 | $ (9,417) | $ 3,705 | $ 77,700 |
| Average earnings assets | $ 2,270,072 | $ 1,934,608 | $ 6,922,171 | $ 7,563,499 | $ 1,127,120 | $ 19,817,470 |

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| | Mortgage Banking | Consumer | Commercial and Corporate | Treasury and Investments | Other | Total |
|---|---|---|---|---|---|---|
| **For the six-month period ended June 30, 2007:** | | | | | | |
| Interest income | $ 80,818 | | | | | |