

FIRST BANCORP /PR/  
Form 10-K  
February 29, 2008

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-K  
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (D) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended December 31, 2007  
Commission File No. 001-14793  
First BanCorp.  
(Exact name of registrant as specified in its charter)**

|  |   |
|--|---|
| <p style="text-align: center;"><b>Puerto Rico</b><br/>(State or other jurisdiction of<br/>incorporation or organization)</p> | <p><b>66-0561882</b><br/>(I.R.S. Employer<br/>Identification No.)</p> |
|--|---|

|  |                                       |
|--|---------------------------------------|
| <p><b>1519 Ponce de León Avenue, Stop 23</b><br/><b>Santurce, Puerto Rico</b></p> <p>(Address of principal executive office)</p> | <p><b>00908</b></p> <p>(Zip Code)</p> |
|--|---------------------------------------|

Registrant's telephone number, including area code:  
**(787) 729-8200**

Securities registered under Section 12(b) of the Act:

| Title of each class  | Name of each exchange on which registered |
|--|---|
| <b>Common Stock (\$1.00 par value)</b>   | <b>New York Stock Exchange</b>            |
| <b>7.125% Noncumulative Perpetual Monthly Income Preferred Stock, Series A (Liquidation Preference \$25 per share)</b> | <b>New York Stock Exchange</b>            |
| <b>8.35% Noncumulative Perpetual Monthly Income Preferred Stock, Series B (Liquidation Preference \$25 per share)</b>  | <b>New York Stock Exchange</b>            |
| <b>7.40% Noncumulative Perpetual Monthly Income Preferred Stock, Series C (Liquidation Preference \$25 per share)</b>  | <b>New York Stock Exchange</b>            |
| <b>7.25% Noncumulative Perpetual Monthly Income Preferred Stock, Series D (Liquidation Preference \$25 per share)</b>  | <b>New York Stock Exchange</b>            |
| <b>7.00% Noncumulative Perpetual Monthly Income Preferred Stock, Series E (Liquidation Preference \$25 per share)</b>  | <b>New York Stock Exchange</b>            |

Securities registered under Section 12(g) of the Act:

**NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15 (d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definite proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer

Accelerated Filer

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

The aggregate market value of the voting common equity held by non affiliates of the registrant as of June 30, 2007 (the last day of the registrant's most recently completed second quarter) was \$ 822,446,217 based on the closing price of \$10.99 per share of common stock on the New York Stock Exchange on June 30, 2007. The registrant had no nonvoting common equity outstanding as of June 30, 2007. For the purposes of the foregoing calculation only, registrant has treated as common stock held by affiliates only common stock of the registrant held by its directors and executive officers and voting stock held by the registrant's employee benefit plans. The registrant's response to this item is not intended to be an admission that any person is an affiliate of the registrant for any purposes other than this response.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 92,504,506 shares as of January 31, 2008.

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**Table of Contents**

**DOCUMENTS INCORPORATED BY REFERENCE**

**PART III**

|         |   |   |
|---------|---|---|
| Item 10 | Directors, Executive Officers and Corporate Governance.   | Information in response to this Item is incorporated into this Annual Report on Form 10-K by reference from the sections entitled Information with Respect to Nominees for Director of First BanCorp, Directors whose Terms Continue and Executive Officers of the Corporation and Corporate Governance and Related Matters in First BanCorp's definitive Proxy Statement for use in connection with its 2008 Annual Meeting of stockholders (the Proxy Statement). |
| Item 11 | Executive Compensation.   | Information in response to this Item is incorporated into this Annual Report on Form 10-K by reference from the sections entitled Compensation Discussion and Analysis, Tabular Executive Compensation Disclosure, Compensation of Directors, and Compensation Committee Report in First BanCorp's Proxy Statement.   |
| Item 12 | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters. | Information in response to this Item is incorporated into this Annual Report on Form 10-K by reference from the section entitled Beneficial Ownership of Securities in First BanCorp's Proxy Statement.   |
| Item 13 | Certain Relationships and Related Transactions, and Director Independence.                      | Information in response to this Item is incorporated into this Annual Report on Form 10-K by reference from the sections entitled Certain Relationships and Related Person Transactions and Corporate Governance and Related Matters in First BanCorp's Proxy Statement.  |
| Item 14 | Principal Accountant Fees and Services.   | Information in response to this Item is incorporated into this Annual Report on Form 10-K by reference from the section entitled Audit Fees in First BanCorp's Proxy Statement.   |

**FIRST BANCORP**  
**2007 ANNUAL REPORT ON FORM 10-K**  
**TABLE OF CONTENTS**

**PART I**

|  |    |
|--|----|
| <u>Item 1. Business</u>  | 6  |
| <u>Item 1A. Risk Factors</u>                                       | 25 |
| <u>Item 1B. Unresolved Staff Comments</u>                          | 30 |
| <u>Item 2. Properties</u>  | 30 |
| <u>Item 3. Legal Proceedings</u>                                   | 31 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 31 |

**PART II**

|   |     |
|---|-----|
| <u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 32  |
| <u>Item 6. Selected Financial Data</u>  | 35  |
| <u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                        | 36  |
| <u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>  | 107 |
| <u>Item 8. Financial Statements and Supplementary Data</u>  | 108 |
| <u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>                         | 108 |
| <u>Item 9A. Controls and Procedures</u>   | 108 |
| <u>Item 9B. Other Information</u>   |     |

**PART III**

|  |     |
|--|-----|
| <u>Item 10. Directors, Executive Officers and Corporate Governance</u>   | 109 |
| <u>Item 11. Executive Compensation</u>   | 109 |
| <u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 109 |
| <u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u>                      | 109 |
| <u>Item 14. Principal Accountant Fees and Services</u>   | 109 |

**PART IV**

|  |     |
|--|-----|
| <u>Item 15. Exhibits and Financial Statement Schedules</u> | 109 |
|--|-----|

**SIGNATURES**

|  |  |
|--|--|
| <u>EX-3.2 BY-LAWS OF FIRST BANCORP</u>               |  |
| <u>EX-14.4 INDEPENDENCE PRINCIPLES FOR DIRECTORS</u> |  |
| <u>EX-21.1 LIST OF FIRST BANCORP'S SUBSIDIARIES</u>  |  |
| <u>EX-31.1 SECTION 302 CERTIFICATION OF THE CEO</u>  |  |
| <u>EX-31.2 SECTION 302 CERTIFICATION OF THE CFO</u>  |  |
| <u>EX-32.1 SECTION 906 CERTIFICATION OF THE CEO</u>  |  |
| <u>EX-32.2 SECTION 906 CERTIFICATION OF THE CFO</u>  |  |

**Table of Contents**

**Forward Looking Statements**

This Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When used in this Form 10-K or future filings by First BanCorp (the Corporation) with the Securities and Exchange Commission (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, are expected to, should, anticipate and similar expressions 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:

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

general economic conditions, including the interest rate scenario 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 as well as other derivative instruments used for protection from interest rate fluctuations;

risks arising from worsening economic conditions in Puerto Rico and in the United States 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;

changes in the Corporation's expenses associated with acquisitions and dispositions;

developments in technology;

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

risks to the Corporation associated with being subject to the Federal Reserve Board of New York (FED) cease and desist order;

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

risks associated with downgrades in the credit ratings of the Corporation's securities;

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 this Annual Report on Form 10-K.



**Table of Contents****PART I****Item 1. Business****GENERAL**

First BanCorp (the Corporation) is a publicly-owned financial holding company that is subject to regulation, supervision and examination by the Federal Reserve Board (the FED). The Corporation was incorporated under the laws of the Commonwealth of Puerto Rico to serve as the bank holding company for FirstBank Puerto Rico (FirstBank or the Bank). The Corporation is a full service provider of financial services and products with operations in Puerto Rico, the United States and the US and British Virgin Islands.

The Corporation provides a wide range of financial services for retail, commercial and institutional clients. As of December 31, 2007, the Corporation controlled four wholly-owned subsidiaries: FirstBank, FirstBank Insurance Agency, Inc. (FirstBank Insurance Agency), Grupo Empresas de Servicios Financieros (d/b/a PR Finance Group) and Ponce General Corporation, Inc. (Ponce General). FirstBank is a Puerto Rico-chartered commercial bank, FirstBank Insurance Agency is a Puerto Rico-chartered insurance agency, PR Finance Group is a domestic corporation and Ponce General is the holding company of a federally chartered stock savings association, FirstBank Florida. FirstBank is subject to the supervision, examination and regulation of both the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico (OCIF) and the Federal Deposit Insurance Corporation (the FDIC). Deposits are insured through the FDIC Deposit Insurance Fund. In addition, within FirstBank, there are two additional separately regulated businesses: (1) the Virgin Islands operations; and (2) the Miami loan agency. The U.S. Virgin Islands operations of FirstBank are subject to regulation and examination by the United States Virgin Islands Banking Board, and the British Virgin Islands operations are subject to regulation by the British Virgin Islands Financial Services Commission. FirstBank's loan agency in the State of Florida is regulated by the Office of Financial Regulation of the State of Florida, the Federal Reserve Bank of Atlanta and the Federal Reserve Bank of New York. As of December 31, 2007, the Corporation had total assets of \$17.2 billion, total deposits of \$11.0 billion and total stockholders' equity of \$1.4 billion.

FirstBank Insurance Agency is subject to the supervision, examination and regulation of the Office of the Insurance Commissioner of the Commonwealth of Puerto Rico and operates fourteen offices in Puerto Rico. PR Finance Group is subject to the supervision, examination and regulation of the OCIF. FirstBank Florida is subject to the supervision, examination and regulation of the Office of Thrift Supervision (the OTS).

As of December 31, 2007, FirstBank conducted its business through its main office located in San Juan, Puerto Rico, forty-eight full service banking branches in Puerto Rico, twenty-two branches in the United States Virgin Islands (USVI) and British Virgin Islands (BVI) and a loan agency in Miami, Florida (USA). FirstBank had four wholly-owned subsidiaries with operations in Puerto Rico: First Leasing and Rental Corporation, a vehicle leasing and daily rental company with seven offices in Puerto Rico; First Federal Finance Corp. (d/b/a Money Express La Financiera), a finance company with thirty-nine offices in Puerto Rico; First Mortgage, Inc. (First Mortgage), a residential mortgage loan origination company with twenty-six offices in FirstBank branches and at stand alone sites; and FirstBank Overseas Corporation, an international banking entity organized under the International Banking Entity Act of Puerto Rico. FirstBank had three subsidiaries with operations outside of Puerto Rico: First Insurance Agency VI, Inc., an insurance agency with two offices that sells insurance products in the USVI; First Express, a finance company specializing in the origination of small loans with three offices in the USVI; and First Trade, Inc. which provides foreign sales corporation management services.

The Corporation operates in the United States mainland through its federally chartered stock savings association First Bank Florida. FirstBank Florida provides a wide range of banking services to individual and corporate customers through its nine branches in the U.S. mainland.



**Table of Contents**

**BUSINESS SEGMENTS**

The Corporation has four reportable segments: Commercial and Corporate Banking; Mortgage Banking; Consumer (Retail) Banking; and Treasury and Investments. These segments are described below:

*Commercial and Corporate Banking*

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. A substantial portion of the commercial loan portfolio is secured by commercial real estate. Although commercial loans involve greater credit risk than a typical mortgage loan because they are larger in size and more risk is concentrated in a single borrower, the Corporation has and maintains an effective credit risk management infrastructure designed to mitigate potential losses associated with commercial lending, including strong underwriting and loan review functions, sales of loan participations and continuous monitoring of concentrations within portfolios.

*Mortgage Banking*

The Mortgage Banking segment conducts its operations mainly through FirstBank and its mortgage origination subsidiary, FirstMortgage. These operations consist of the origination, sale and servicing of a variety of residential mortgage loans products. Originations are sourced through different channels, such as branches and mortgage and real estate brokers, and in association with new project developers. FirstMortgage focuses on originating residential real estate loans, some of which conform to Federal Housing Administration (FHA), Veterans Administration (VA) and Rural Development (RD) standards. Loans originated that meet FHA standards qualify for the federal agency's insurance program whereas loans that meet VA and RD standards are guaranteed by their respective federal agencies. Mortgage loans that do not qualify under these programs are commonly referred to as conventional loans. Conventional real estate loans could be conforming and non-conforming. Conforming loans are residential real estate loans that meet the standards for sale under the Fannie Mae and Freddie Mac programs whereas loans that do not meet the standards are referred to as non-conforming residential real estate loans. The Corporation's strategy is to penetrate markets by seeking to provide customers with a variety of high quality mortgage products to serve their financial needs faster and more easily than the competition and at competitive prices. The Mortgage Banking segment also acquires and sells mortgages in the secondary markets. From time to time, residential real estate conforming loans are sold to secondary buyers like Fannie Mae and Freddie Mac. More than 90% of the Corporation's residential mortgage loan portfolio consists of fixed-rate, fully amortizing, full documentation loans that have a lower risk than the typical sub-prime loans that have already affected the U.S. real estate market. The Corporation is not active in negative amortization loans or option adjustable rate mortgage loans (ARMs) including ARMs with teaser rates.

*Consumer (Retail) Banking*

The Consumer (Retail) Banking segment consists of the Corporation's consumer lending and deposit-taking activities conducted mainly through its branch network and loan centers. Loans to consumers include auto, credit card and personal loans. Deposit products include checking and savings accounts, Individual Retirement Accounts (IRA) and retail certificates of deposit. Retail deposits gathered through each branch of FirstBank's retail network serve as one of the funding sources for lending and investment activities.

Consumer lending growth has been mainly driven by auto loan originations. The growth of this portfolio has been achieved through a strategy of providing outstanding service to selected auto dealers who provide the channel for the bulk of the Corporation's auto loan originations. This strategy is directly linked to the Corporation's commercial lending activities as the Corporation maintains strong and stable auto floor plan relationships, which are the foundation of a successful auto loan generation operation. The Corporation continues to strengthen commercial relations with floor plan dealers, which directly benefit the Corporation's consumer lending operation and are managed as part of the consumer banking activities.

**Table of Contents**

Personal loans and, to a lesser extent, marine financing and a small credit card portfolio also contribute to interest income generated on consumer lending. Management plans to continue to be active in the consumer loans market, applying the Corporation's strict underwriting standards.

*Treasury and Investments*

The Treasury and Investments segment is responsible for the Corporation's investment portfolio and treasury functions designed to manage and enhance liquidity. This segment sells funds to the Commercial and Corporate Banking, Mortgage Banking, and Consumer (Retail) Banking segments to finance their lending activities and purchases funds gathered by those segments.

The interest rates charged or credited by Treasury and Investments are based on market rates.

For information regarding First BanCorp's reportable segments, please refer to Note 31, Segment Information, to the Corporation's financial statements for the year ended December 31, 2007 included in Item 8 of this Form 10-K.

**Employees**

As of December 31, 2007, the Corporation and its subsidiaries employed approximately 3,000 persons. None of its employees are represented by a collective bargaining group. The Corporation considers its employee relations to be good.

**RECENT SIGNIFICANT EVENTS**

***Settlement of Class Action Lawsuit***

On November 28, 2007, the United States District Court for the District of Puerto Rico approved the settlement of all claims in the consolidated securities class action relating to the accounting for mortgage-related transactions named In Re: First BanCorp Securities Litigations.

Under the terms of the settlement, the Corporation paid an aggregate of \$74.25 million. The monetary payment had no impact on the Corporation's earnings or capital in 2007. As reflected in First BanCorp's audited Consolidated Financial Statements for 2005, included in the Corporation's 2005 Annual Report on Form 10-K, the Corporation accrued \$74.25 million in 2005 for the potential settlement of the class action lawsuit. In 2007, the Corporation recognized income of approximately \$15.1 million from an agreement reached with insurance companies and former executives of the Corporation for indemnity of expenses, which was accounted for as Insurance Reimbursements and Other Agreements Related to a Contingency Settlement on the Consolidated Statement of Income.

***SEC Investigation***

On August 7, 2007, First BanCorp announced that the SEC had approved a final settlement with the Corporation, which resolved the previously disclosed SEC investigation of the Corporation's accounting for the mortgage-related transactions with Doral Financial Corporation (Doral) and R&G Financial Corporation (R&G Financial).

Under the settlement with the SEC, the Corporation agreed, without admitting or denying any wrongdoing, to the issuance of a Federal Court Order enjoining it from committing future violations of certain provisions of the federal securities laws. The Corporation also agreed to the payment of an \$8.5 million civil penalty and the disgorgement of \$1 to the SEC. The SEC may request that the civil penalty be subject to distribution pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002. The monetary payment had no impact on the Corporation's earnings or capital in 2007. As reflected in First BanCorp's previously filed audited Consolidated Financial Statements for 2005, the Corporation accrued \$8.5 million in 2005 for the potential settlement with the SEC. In connection with the settlement, the Corporation consented to the entry of a final judgment to implement

**Table of Contents**

the terms of the agreement. The United States District Court for the Southern District of New York consented to the entry of the final judgment in order to consummate the settlement. The monetary payment was made on October 15, 2007.

***Regulatory Actions***

On November 20, 2007, the Corporation announced that, following the most recent Safety and Soundness examination of FirstBank, the FDIC and the OCIF terminated the Order to Cease and Desist dated March 16, 2006 related to the mortgage-related transactions with other financial institutions and the Order to Cease and Desist dated August 24, 2006 related to the Bank's compliance with the Bank Secrecy Act (BSA).

In February 2006, the OTS imposed restrictions on FirstBank Florida as a result of safety and soundness concerns derived from the Company's previous announcement that it would restate its financial statements. Under these restrictions, FirstBank Florida cannot make any payments to the Corporation or its affiliates pursuant to a tax-sharing agreement nor can FirstBank Florida employ or receive consultative services from an executive officer of the Corporation or its affiliates without the prior written approval of OTS Regional Director. Additionally, FirstBank Florida cannot enter into any agreement to sell loans or any portions of any loans to the Corporation or its affiliates nor can FirstBank Florida make any payment to the Corporation or its affiliates via an intercompany account or arrangement unless pursuant to a pre-existing contractual agreement for services rendered in the normal course of business. Also, FirstBank Florida cannot pay dividends to its parent, Ponce General, a wholly owned subsidiary of First BanCorp, without prior approval from the OTS.

On March 17, 2006, the Corporation announced that it had agreed with the FED to a cease and desist order issued with the consent of the Corporation (the Consent Order). The Consent Order addresses certain concerns of banking regulators relating to the incorrect accounting for and documentation of mortgage-related transactions with Doral and R&G. The Corporation had initially reported those transactions as purchases of mortgage loans when they should have been accounted for as secured loans to the financial institutions because, as a legal and accounting matter, they did not constitute true sales but rather financing arrangements. The Consent Order requires the Corporation to take various affirmative actions, including engaging an independent consultant to review the mortgage portfolios and prepare a report including findings and recommendations, submitting capital and liquidity contingency plans, providing notice prior to the incurring of additional debt or the restructuring or repurchasing of debt, obtaining approval prior to purchasing or redeeming stock, filing amended regulatory reports upon completion of the restatement of financial statements, and obtaining regulatory approval prior to paying dividends after those payable in March 2006. The requirements of the Consent Order have been substantially completed and reported to the regulator as required by the Consent Order.

The Corporation has continued working on the reduction of its exposure to Doral and R&G. The outstanding balance of loans to Doral and R&G amounted to \$382.6 million and \$242.0 million, respectively, as of December 31, 2007.

During the first quarter of 2007, the Corporation entered into various agreements with R&G relating to prior transactions accounted for as commercial loans secured by mortgage loans and pass-through trust certificates from R&G subsidiaries. First, through a mortgage payment agreement, R&G paid the Corporation approximately \$50 million to reduce the commercial loan that R&G Premier Bank, R&G's banking subsidiary, had outstanding with the Corporation. In addition, the remaining balance of \$271 million was re-documented as a secured loan from the Corporation to R&G. Second, R&G 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 allow the Corporation to treat these transactions as true sales for accounting and legal purposes, as such, these commercial loans secured by trust certificates were classified as available for sale securities. The execution of the agreements enabled the Corporation to fulfill the remaining requirements of the Consent Order with banking regulators relating to the mortgage-related transactions that the Corporation recharacterized for accounting and legal purposes as commercial loans secured by the mortgage loans and pass-through trust certificates.

***Restatement***

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With the filing during 2007 of the 2006 Form 10-K for the fiscal year ended December 31, 2006, the quarterly financial statements on Form 10-Q for 2007 quarters and the quarterly financial statements on Form 10-Q for 2006

**Table of Contents**

quarters (which includes restated financial information for March 31, 2005 and the 2004 quarters) the Corporation became current with its SEC periodic reporting obligations.

***Issuance of common equity***

On August 24, 2007, First BanCorp entered into a Stockholder Agreement relating to its sale in a private placement of 9,250,450 shares or 10% of the Corporation's common stock ( Common Stock ) to The Bank of Nova Scotia ( Scotiabank ), a large financial institution with operations around the world, at a price of \$10.25 per share pursuant to the terms of an Investment Agreement, dated February 15, 2007 (the Investment Agreement ). The net proceeds to First BanCorp after discounts and expenses were \$91.9 million. The securities sold to Scotiabank were issued pursuant to the exemption from registration in Section 4(2) of the Securities Act of 1933, as amended. Pursuant to the Investment Agreement, Scotiabank has the right to require the Corporation to register the Common Stock for resale by Scotiabank, or successor owners of the Common Stock.

First BanCorp has agreed to give Scotiabank notice if any decision to commence a process involving the sale of First BanCorp during the 18 months after Scotiabank's investment is made, and to negotiate with Scotiabank exclusively for 30 days thereafter if Scotiabank so requests. In addition, during the 18-month period Scotiabank may give notice to First BanCorp providing its offer to acquire the Corporation. First BanCorp has agreed to negotiate the offer received on an exclusive basis for a period of 30 days. Also, First BanCorp has agreed to give Scotiabank notice of the terms of any proposed acquisition received from a third party during the 18-month period and to allow Scotiabank five business days to indicate whether it will present a counteroffer. Finally, Scotiabank is entitled to an observer at meetings of the Board of Directors of First BanCorp, including any committee meetings of the Board of Directors of First BanCorp subject to certain limitations. The observer has no voting rights.

***Business Developments***

On January 28, 2008, FirstBank acquired Virgin Islands Community Bank (VICB) in St. Croix, U.S. Virgin Islands. VICB has three branches on St. Croix and deposits of approximately \$56 million.

***Recent Puerto Rico Legislation***

On December 10, 2007, the Governor of Puerto Rico signed Act No. 181 ( Act 181 ). Act 181 reduces the special tax rate on long term capital gains applicable to individuals, estates and trusts from 12.5% to 10%. In the case of the sale of real property or stock by nonresident individuals the applicable rate will be 25%, however, if the individual is a U.S. citizen, the rate will be 10%. The special tax rate on long term capital gains for corporations and partnerships was reduced from 20% to 15%. The special tax rates established by Act 181 will apply only to transactions that occurred on July 1, 2007 and after.

On December 14, 2007, the Governor of Puerto Rico signed Act No. 197 ( Act 197 ) which provides certain credits when individuals purchase certain new or existing homes. The incentives are as follows: (a) for a new constructed home that will constitute the individuals principal residence, a credit equal to 20% of the sales price or \$25,000, whichever is lower; (b) for new constructed homes that will not constitute the individuals principal residence, a credit of 10% of the sales price or \$15,000, whichever is lower; and (c) for existing homes a credit of 10% of the sales price or \$10,000, whichever is lower. Credits under Act 197 need to be certified by the Secretary of Treasury and the maximum amount of credits to be granted under Act 197 is \$220,000,000.

From the homebuyer's perspective: (1) the individual may benefit from the credit no more than twice; (2) the amount of credit granted will be credited against the principal amount of the mortgage; (3) the individual must acquire the property before June 30, 2008; and (4) for new constructed homes constituting the principal residence and existing homes, the individual must live in it as his or her principal residence at least three consecutive years. Noncompliance with this requirement will affect only the homebuyer's credit and not the tax credit granted to the financial institution.

From the financial institution's perspective: (1) the credit may be used against income taxes, including estimated taxes, for years commencing after December 31, 2007 in three installments, subject to certain limitations, between January 1, 2008 and June 30, 2011; (2) the credit may be ceded, sold or otherwise transferred to any other

**Table of Contents**

person; and (3) any tax credit not used in a given tax year, as certified by the Secretary of Treasury, may be claimed as a refund.

***Credit Ratings***

On December 6, 2007, Standard & Poors ( S&P ), a division of the McGraw Hill Companies, Inc., affirmed the BB+ long-term counterparty credit rating of First Bank. At the same time, S&P removed the rating from CreditWatch with negative implications where it was placed on October 3, 2005 to stable outlook. On February 21, 2007, Fitch Ratings, Ltd., a subsidiary of Fimalac, S.A., affirmed First BanCorp s long-term issuer default rating of BB and removed the Corporation from Rating Watch Negative. The rating outlook is negative.

**WEBSITE ACCESS TO REPORT**

The Corporation makes available annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934, free of charge on or through our internet website at [www.firstbankpr.com](http://www.firstbankpr.com), ( Sobre nosotros section, SEC Filings link), as soon as reasonably practicable after the Corporation electronically files such material with, or furnishes it to, the SEC.

The Corporation also makes available the Corporation s corporate governance standards, the charters of the audit, compensation and benefits, corporate governance and nominating committees and the codes mentioned below, free of charge on or through our internet website at [www.firstbankpr.com](http://www.firstbankpr.com) ( Sobre nosotros, Governance Documents link):

Code of Ethics for Senior Financial Officers

Code of Ethics applicable to all employees

Independence Principles for Directors

The corporate governance standards, and the aforementioned charters and codes may also be obtained free of charge by sending a written request to Mr. Lawrence Odell, Executive Vice President and General Counsel, PO Box 9146, San Juan, Puerto Rico 00908.

The public may read and copy any materials First BanCorp files with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. In addition, the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy, and information statements, and other information regarding issuers that file electronically with the SEC at its website ([www.sec.gov](http://www.sec.gov) ).

**Table of Contents**

**MARKET AREA AND COMPETITION**

Puerto Rico, where the banking market is highly competitive, is the main geographic service area of the Corporation. As of December 31, 2007, the Corporation also had a presence through its subsidiaries in the United States and British Virgin Islands and through its loan agency and its federally chartered stock savings association in Florida (USA). Puerto Rico banks are subject to the same federal laws, regulations and supervision that apply to similar institutions in the United States mainland.

Competitors include other banks, insurance companies, mortgage banking companies, small loan companies, automobile financing companies, leasing companies, vehicle rental companies, brokerage firms with retail operations, and credit unions in Puerto Rico, the Virgin Islands and the state of Florida. The Corporation's businesses compete with these other firms with respect to the range of products and services offered and the types of clients, customers, and industries served.

The Corporation's ability to compete effectively depends on the relative performance of its products, the degree to which the features of its products appeal to customers, and the extent to which the Corporation meets clients' needs and expectations. The Corporation's ability to compete also depends on its ability to attract and retain professional and other personnel, and on its reputation.

The Corporation encounters intense competition in attracting and retaining deposits and in its consumer and commercial lending activities. The Corporation competes for loans with other financial institutions, some of which are larger and have greater resources available than those of the Corporation. Management believes that the Corporation has been able to compete effectively for deposits and loans by offering a variety of transaction account products and loans with competitive features, by pricing its products at competitive interest rates, by offering convenient branch locations, and by emphasizing the quality of its service. The Corporation's ability to originate loans depends primarily on the rates and fees charged and the service it provides to its borrowers in making prompt credit decisions. There can be no assurance that in the future the Corporation will be able to continue to increase its deposit base or originate loans in the manner or on the terms on which it has done so in the past.

**SUPERVISION AND REGULATION**

***Bank Holding Company Activities and Other Limitations***

The Corporation is subject to ongoing regulation, supervision, and examination by the Federal Reserve Board, and is required to file with the Federal Reserve Board periodic and annual reports and other information concerning its own business operations and those of its subsidiaries. In addition, under the provisions of the Bank Holding Company Act, a bank holding company must obtain Federal Reserve Board approval before it acquires directly or indirectly ownership or control of more than 5% of the voting shares of another bank, or merges or consolidates with another bank holding company. The Federal Reserve Board also has authority under certain circumstances to issue cease and desist orders against bank holding companies and their non-bank subsidiaries.

A bank holding company is prohibited under the Bank Holding Company Act, with limited exceptions, from engaging, directly or indirectly, in any business unrelated to the businesses of banking or managing or controlling banks. One of the exceptions to these prohibitions permits ownership by a bank holding company of the shares of any corporation if the Federal Reserve Board, after due notice and opportunity for hearing, by regulation or order has determined that the activities of the corporation in question are so closely related to the businesses of banking or managing or controlling banks as to be a proper incident thereto.

Under the Federal Reserve Board policy, a bank holding company such as the Corporation is expected to act as a source of financial strength to its banking subsidiaries and to commit support to them. This support may be required at times when, absent such policy, the bank holding company might not otherwise provide such support. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain capital of a subsidiary bank will be assumed by the bankruptcy trustee and be entitled to a priority of payment. In addition, any capital loans by a bank holding company to any of its subsidiary banks

**Table of Contents**

must be subordinated in right of payment to deposits and to certain other indebtedness of such subsidiary bank. As of December 31, 2007, FirstBank and FirstBank Florida were the only depository institution subsidiaries of the Corporation.

The Gramm-Leach-Bliley Act revised and expanded the provisions of the Bank Holding Company Act by including a section that permits a bank holding company to elect to become a financial holding company to engage in a full range of financial activities. The Gramm-Leach-Bliley Act requires a bank holding company that elects to become a financial holding company to file a written declaration with the appropriate Federal Reserve Bank and comply with the following (and such compliance must continue while the entity is treated as a financial holding company): (i) state that the bank holding company elects to become a financial holding company; (ii) provide the name and head office address of the bank holding company and each depository institution controlled by the bank holding company; (iii) certify that all depository institutions controlled by the bank holding company are well-capitalized as of the date the bank holding company files for the election; (iv) provide the capital ratios for all relevant capital measures as of the close of the previous quarter for each depository institution controlled by the bank holding company; and (v) certify that all depository institutions controlled by the bank holding company are well-managed as of the date the bank holding company files the election. All insured depository institutions controlled by the bank holding company must have also achieved at least a rating of satisfactory record of meeting community credit needs under the Community Reinvestment Act during the depository institution's most recent examination. In April 2000, the Corporation filed an election with the Federal Reserve Board and became a financial holding company.

Financial holding companies may engage, directly or indirectly, in any activity that is determined to be (i) financial in nature, (ii) incidental to such financial activity, or (iii) complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The Gramm-Leach-Bliley Act specifically provides that the following activities have been determined to be financial in nature: (a) lending, trust and other banking activities; (b) insurance activities; (c) financial or economic advice or services; (d) pooled investments; (e) securities underwriting and dealing; (f) existing bank holding company domestic activities; (g) existing bank holding company foreign activities; and (h) merchant banking activities. The Corporation offers insurance agency services through its wholly-owned subsidiary, FirstBank Insurance Agency and through First Insurance Agency V. I., Inc., a subsidiary of FirstBank.

In addition, the Gramm-Leach-Bliley Act specifically gives the Federal Reserve Board the authority, by regulation or order, to expand the list of financial or incidental activities, but requires consultation with the U.S. Treasury, and gives the Federal Reserve Board authority to allow a financial holding company to engage in any activity that is complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Under the Gramm-Leach-Bliley Act, if the Corporation fails to meet any of the requirements for being a financial holding company and is unable to resolve such deficiencies within certain prescribed periods of time, the Federal Reserve Board could require the Corporation to divest control of one or more of its depository institution subsidiaries or alternatively cease conducting financial activities that are not permissible for bank holding companies that are not financial holding companies.

***Sarbanes-Oxley Act***

On July 20, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (SOA), which implemented legislative reforms intended to address corporate and accounting fraud. SOA contains reforms of various business practices and numerous aspects of corporate governance. Most of these requirements have been implemented by regulations issued by the SEC. The following is a summary of certain key provisions of SOA.

In addition to the establishment of an accounting oversight board that enforces auditing, quality control and independence standards and is funded by fees from all publicly traded companies, SOA places restrictions on the scope of services that may be provided by accounting firms to their public corporation audit clients. Any non-audit services being provided to a public corporation audit client requires pre-approval by the corporation's audit committee. In addition, SOA makes certain changes to the requirements for rotation of certain persons involved in the audit after a period of time. SOA requires chief executive officers and chief financial officers, or their





**Table of Contents**

equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willingly violate this certification requirement. In addition, counsel is required to report evidence of a material violation of the securities laws or a breach of fiduciary duties to the corporation's chief executive officer or its chief legal officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Under SOA, longer prison terms may apply to corporate executives who violate federal securities laws; the period during which certain types of suits can be brought against a corporation or its officers is extended; and bonuses and other equity-based compensation received by the Chief Executive Officer and Chief Financial Officer prior to restatement of a corporation's financial statements are now subject to disgorgement if such restatement was due to misconduct. Executives are also prohibited from insider trading during retirement plan blackout periods, and loans to corporations' executives and directors (other than loans by financial institutions permitted by federal rules or regulations) are prohibited. In addition, as a result of the legislation, public companies must make certain disclosures on an accelerated basis and directors and executive officers must report changes in ownership in a corporation's securities within two business days of the change.

SOA increases responsibilities and codifies certain requirements related to audit committees of public companies and how they interact with the corporation's registered public accounting firm. Audit committee members must be independent and are barred from accepting consulting, advisory or other compensatory fees from the issuer. In addition, companies are required to disclose whether at least one member of the committee is a financial expert (as such term is defined by the SEC) and if not, the reasons why. A corporation's registered public accounting firm is prohibited from performing statutorily mandated audit services for a corporation if the corporation's chief executive officer, chief financial officer, controller, chief accounting officer or any person serving in equivalent positions had been employed by such firm and participated in the audit of such corporation during the one-year period preceding the audit initiation date. SOA also prohibits any officer or director of a corporation or any other person acting under their direction from taking any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the audit of the corporation's financial statements for the purpose of rendering the financial statements materially misleading.

SOA also has provisions relating to inclusion of management's assessment of internal control over financial reporting in the annual report on Form 10-K. The law also requires the corporation's independent registered public accounting firm that issues the audit report to attest to and report on the effectiveness of internal control over financial reporting. Since the 2004 Annual Report on Form 10-K, the Corporation has included its management's assessment regarding the effectiveness of the Corporation's internal control over financial reporting. The internal control report includes a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the Corporation; management's assessment as to the effectiveness of the Corporation's internal control over financial reporting based on management's evaluation, as of year-end; and the framework used by management as criteria for evaluating the effectiveness of the Corporation's internal control over financial reporting. As of December 31, 2007, First BanCorp's management concluded that its internal control over financial reporting was effective based on the criteria set forth in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). The Corporation's independent registered public accounting firm reached the same conclusion.

***USA Patriot Act***

Under Title III of the USA Patriot Act, also known as the International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001, all financial institutions are required to, among other things, identify their customers, adopt formal and comprehensive anti-money laundering programs, scrutinize or prohibit altogether certain transactions of special concern, and be prepared to respond to inquiries from U.S. law enforcement agencies concerning their customers and their transactions. Presently, only certain types of financial institutions (including banks, savings associations and money services businesses) are subject to final rules implementing the anti-money laundering program requirements of the USA Patriot Act.

Failure of a financial institution to comply with the USA Patriot Act's requirements could have serious legal and reputational consequences for the institutions. The Corporation has adopted appropriate policies, procedures and

controls to address compliance with the USA Patriot Act and U.S. Treasury Department regulations.

**Table of Contents*****Privacy Policies***

Under the Gramm-Leach-Bliley Act, all financial institutions are required to adopt privacy policies, restrict the sharing of nonpublic customer data with parties at the customer's request and establish policies and procedures to protect customer data from unauthorized access. The Corporation and its subsidiaries have adopted policies and procedures in order to comply with the privacy provisions of the Gramm-Leach-Bliley Act and the Fair and accurate Credit Transaction Act of 2003 and the regulations issued thereunder.

***State Chartered Non-Member Bank; Federal Savings Bank; Banking Laws and Regulations in General***

FirstBank is subject to extensive regulation and examination by the OCIF and the FDIC, and is subject to certain requirements established by the Federal Reserve Board. FirstBank Florida is a federally regulated savings bank subject to extensive regulation and examination by the OTS, and subject to certain Federal Reserve regulations. The federal and state laws and regulations which are applicable to banks and savings banks regulate, among other things, the scope of their businesses, their investments, their reserves against deposits, the timing and availability of deposited funds, and the nature and amount of and collateral for certain loans. In addition to the impact of regulations, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy. References herein to applicable statutes or regulations are brief summaries of portions thereof which do not purport to be complete and which are qualified in their entirety by reference to those statutes and regulations. Any change in applicable laws or regulations may have a material adverse effect on the business of commercial banks, thrifts and bank holding companies, including FirstBank, FirstBank Florida and the Corporation. However, management is not aware of any current proposals by any federal or state regulatory authority that, if implemented, would have or would be reasonably likely to have a material effect on the liquidity, capital resources or operations of FirstBank, FirstBank Florida or the Corporation.

As a creditor and financial institution, FirstBank is subject to certain regulations promulgated by the Federal Reserve Board, including, without limitation, Regulation B (Equal Credit Opportunity Act), Regulation DD (Truth in Savings Act), Regulation E (Electronic Funds Transfer Act), Regulation F (Limits on Exposure to Other Banks), Regulation O (Loans to Executive Officers, Directors and Principal Shareholders), Regulation Z (Truth in Lending Act), Regulation CC (Expedited Funds Availability Act), Regulation X (Real Estate Settlement Procedures Act), Regulation BB (Community Reinvestment Act) and Regulation C (Home Mortgage Disclosure Act). On December 18, 2007, the Federal Reserve Board proposed for public comment certain changes to Regulation Z (Truth in Lending) to protect consumers from unfair or deceptive home mortgage lending and advertising practices. The proposed regulation would prohibit a lender from engaging in a pattern or practice of lending without considering a borrower's ability to repay the loans from sources other than the home's value, and prohibit a lender from making a loan by relying on income or assets that it does not verify. Comments are due on this proposal in March 2008, and regulations could be issued later this year.

There are periodic examinations by the OCIF and the FDIC of FirstBank and by the OTS of FirstBank Florida to test each bank's compliance with various statutory and regulatory requirements. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the FDIC's insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties. In general, these enforcement actions may be initiated for violations of laws and regulations and for engaging in unsafe or unsound practices. In addition, certain bank actions are required by statute and implementing regulations. Other actions or failure to act may provide the basis for enforcement action, including the filing of misleading or untimely reports with regulatory authorities.

**Table of Contents**

On August 3, 2007, the OTS issued an advance notice of proposed rulemaking under its authority contained in the Federal Trade Commission Act as to unfair or deceptive acts or practices. This new rule would apply only to savings associations, and would likely address the issues that arise in the context of mortgage lending or servicing. The OTS asks whether existing bank regulatory guidance on unfairness or deception, such as the guidelines for residential mortgage lending practices adopted by the Office of the Comptroller of the Currency should be addressed in regulation form. This advance notice could result in additional regulation of credit practices to address a variety of consumer protection issues.

The U.S. Congress is also considering legislation which would affect mortgage lending in the United States by establishing a national standard as to abusive lending practices, including a minimum standard requiring that borrowers have a reasonable ability to repay the loan. The House of Representatives passed The Mortgage Reform and Anti-Predatory Lending Act of 2007 on November 15, 2007. It is unclear whether legislation in this area will become law.

***Dividend Restrictions***

The Corporation is subject to certain restrictions generally imposed on Puerto Rico corporations with respect to the declaration and payment of dividends (i.e., that dividends may be paid out only from the Corporation's net assets in excess of capital or, in the absence of such excess, from the Corporation's net earnings for such fiscal year and/or the preceding fiscal year). The Federal Reserve Board has also issued a policy statement that provides that bank holding companies should generally pay dividends only out of current operating earnings.

As of December 31, 2007, the principal source of funds for the Corporation is dividends declared and paid by its subsidiary, FirstBank. The ability of FirstBank to declare and pay dividends on its capital stock is regulated by the Puerto Rico Banking Law, the Federal Deposit Insurance Act (the FDIA), and FDIC regulations. In general terms, the Puerto Rico Banking Law provides that when the expenditures of a bank are greater than receipts, the excess of expenditures over receipts shall be charged against undistributed profits of the bank and the balance, if any, shall be charged against the required reserve fund of the bank. If the reserve fund is not sufficient to cover such balance in whole or in part, the outstanding amount must be charged against the bank's capital account. The Puerto Rico Banking Law provides that, until said capital has been restored to its original amount and the reserve fund to 20% of the original capital, the bank may not declare any dividends.

In general terms, the FDIA and the FDIC regulations restrict the payment of dividends when a bank is undercapitalized, when a bank has failed to pay insurance assessments, or when there are safety and soundness concerns regarding such bank.

In addition, the Consent Order with the Federal Reserve imposes certain restrictions on dividend payments. The Corporation may not pay dividends or other payments without the permission of the Federal Reserve Bank. The Federal Reserve Bank has approved all requests for approval of dividend declarations since the Corporation agreed to the Consent Order.

***Limitations on Transactions with Affiliates and Insiders***

Certain transactions between financial institutions such as FirstBank and FirstBank Florida and affiliates are governed by Sections 23A and 23B of the Federal Reserve Act and by Regulation W. An affiliate of a financial institution is any corporation or entity, that controls, is controlled by, or is under common control with the financial institution. In a holding company context, the parent bank holding company and any companies which are controlled by such parent bank holding company are affiliates of the financial institution. Generally, Sections 23A and 23B of the Federal Reserve Act (i) limit the extent to which the financial institution or its subsidiaries may engage in covered transactions (defined below) with any one affiliate to an amount equal to 10% of such financial institution's capital stock and surplus, and contain an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such financial institution's capital stock and surplus and (ii) require that all covered transactions be on terms substantially the same, or at least as favorable to the financial institution or affiliate, as those provided to a non-affiliate. The term covered transaction includes the making of loans, purchase of assets, issuance of a guarantee and other similar transactions. In addition, loans or other extensions of credit by the financial

**Table of Contents**

institution to the affiliate are required to be collateralized in accordance with the requirements set forth in Section 23A of the Federal Reserve Act.

The Gramm-Leach-Bliley Act requires that financial subsidiaries of banks be treated as affiliates for purposes of Sections 23A and 23B of the Federal Reserve Act, but (i) the 10% capital limitation on transactions between the bank and such financial subsidiary as an affiliate is not applicable, and (ii) notwithstanding other provisions in Sections 23A and 23B, the investment by the bank in the financial subsidiary does not include retained earnings of the financial subsidiary. The Gramm-Leach-Bliley Act provides that: (1) any purchase of, or investment in, the securities of a financial subsidiary by any affiliate of the parent bank is considered a purchase or investment by the bank; and (2) if the Federal Reserve Board determines that such treatment is necessary, any loan made by an affiliate of the parent bank to the financial subsidiary is to be considered a loan made by the parent bank.

The Federal Reserve Board has adopted Regulation W which interprets the provisions of Sections 23A and 23B. The regulation unifies and updates staff interpretations issued over the years, incorporates several new interpretations and provisions (such as to clarify when transactions with an unrelated third party will be attributable to an affiliate), and addresses new issues arising as a result of the expanded scope of nonbanking activities engaged in by banks and bank holding companies in recent years and authorized for financial holding companies under the Gramm-Leach-Bliley Act.

In addition, Sections 22(h) and (g) of the Federal Reserve Act, implemented through Regulation O, place restrictions on loans to executive officers, directors, and principal stockholders. Under Section 22(h) of the Federal Reserve Act, loans to a director, an executive officer, a greater than 10% stockholder of a financial institution, and certain related interests of these, may not exceed, together with all other outstanding loans to such persons and affiliated interests, the financial institution's loans to one borrower limit, generally equal to 15% of the institution's unimpaired capital and surplus. Section 22(h) of the Federal Reserve Act also requires that loans to directors, executive officers, and principal stockholders be made on terms substantially the same as offered in comparable transactions to other persons and also requires prior board approval for certain loans. In addition, the aggregate amount of extensions of credit by a financial institution to insiders cannot exceed the institution's unimpaired capital and surplus. Furthermore, Section 22(g) of the Federal Reserve Act places additional restrictions on loans to executive officers. On December 6, 2006, the Federal Reserve Board announced the approval of, and invited public consent on, an interim rule amending Regulation O that will eliminate several statutory reporting and disclosure requirements relating to insider lending. The interim rule does not alter the substantial restrictions on loans by insured depository institutions to their insiders.

The Consent Order with the FED imposed some additional restrictions and reporting requirements on the Corporation. Under this Consent Order, the Corporation and its Non-Bank affiliates shall not, directly or indirectly, enter into, participate, or in any other manner engage in any covered transaction with the Subsidiary Banks, except as permitted by section 23A of the Federal Reserve Act; shall not directly or indirectly, enter into, participate, or in any other manner engage in any transaction with any Insider without the prior written approval; and must submit a monthly report summarizing all covered transactions, as defined in section 23A of the Federal Reserve Act, between First BanCorp, the Non-Bank Affiliates, and the Subsidiary Banks.

In February 2006, the OTS imposed restrictions on FirstBank Florida, formerly Unibank, a subsidiary acquired by First BanCorp in March 2005. Under these restrictions, FirstBank Florida cannot make any payments to the Corporation or its affiliates pursuant to a tax-sharing agreement nor can the bank employ or receive consultative services from an executive officer of the Corporation or its affiliates without the prior written approval of the OTS Regional Director. Additionally, FirstBank Florida cannot enter into any agreement to sell loans or any portions of any loans to the Corporation or its affiliates nor can the bank make any payment to the Corporation or its affiliates via an intercompany account or arrangement unless pursuant to a pre-existing contractual agreement for services rendered in the normal course of business.

***Federal Reserve Board Capital Requirements***

The Federal Reserve Board has adopted capital adequacy guidelines pursuant to which it assesses the adequacy of capital in examining and supervising a bank holding company and in analyzing applications to it under the Bank Holding Company Act. The Federal Reserve Board capital adequacy guidelines generally require bank holding



**Table of Contents**

companies to maintain total capital equal to 8% of total risk-adjusted assets, with at least one-half of that amount consisting of Tier I or core capital and up to one-half of that amount consisting of Tier II or supplementary capital. Tier I capital for bank holding companies generally consists of the sum of common stockholders' equity and perpetual preferred stock, subject in the case of the latter to limitations on the kind and amount of such perpetual preferred stock that may be included as Tier I capital, less goodwill and, with certain exceptions, other intangibles. Tier II capital generally consists of hybrid capital instruments, perpetual preferred stock that is not eligible to be included as Tier I capital, term subordinated debt and intermediate-term preferred stock and, subject to limitations, allowances for loan losses. Assets are adjusted under the risk-based guidelines to take into account different risk characteristics, with the categories ranging from 0% (requiring no additional capital) for assets such as cash to 100% for the bulk of assets, which are typically held by a bank holding company, including multi-family residential and commercial real estate loans, commercial business loans and commercial loans. Off-balance sheet items also are adjusted to take into account certain risk characteristics.

In addition to the risk-based capital requirements, the Federal Reserve Board requires bank holding companies to maintain a minimum leverage capital ratio of Tier I capital to total assets of 3.0%. Total assets for purposes of this calculation do not include goodwill and any other intangible assets and investments that the Federal Reserve Board determines should be deducted. The Federal Reserve Board has announced that the 3.0% Tier I leverage capital ratio requirement is the minimum for the top-rated bank holding companies without supervisory, financial or operational weaknesses or deficiencies or those which are not experiencing or anticipating significant growth. Other bank holding companies will be expected to maintain Tier I leverage capital ratios of at least 4.0% or more, depending on their overall condition. As of December 31, 2007, the Corporation exceeded each of its capital requirements and was a well-capitalized institution as defined in the Federal Reserve Board regulations.

The federal banking agencies are currently analyzing regulatory capital requirements as part of an effort to implement the Basel Committee on Banking Supervision's new capital adequacy framework for large, internationally active banking organizations (Basel II), as well as to update their risk-based capital standards to enhance the risk-sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions that may be raised by U.S. implementation of the Basel II framework. Accordingly, the federal agencies, including the Federal Reserve Board and the FDIC, are considering several revisions to regulations issued in response to an earlier set of standards published by the Basel Committee in 1988 (Basel I). On September 25, 2006, the banking agencies proposed in a notice of proposal a new risk-based capital adequacy framework under Basel II. The framework is intended to produce risk-based capital requirements that are more risk-sensitive than the existing risk-based capital rules. On February 15, 2007, U.S. banking agencies released proposed supervisory guidance to accompany the September Basel II notice of proposed rulemaking. The guidance includes standards to promote safety and soundness and to encourage the comparability of regulatory capital measures across banks.

A final rule implementing advanced approaches of Basel II was published jointly by the U.S. banking agencies on December 7, 2007. This rule establishes regulatory capital requirements and supervisory expectations for credit and operational risks for banks that choose or are required to adopt the advanced approaches, and articulates enhanced standards for the supervisory review of capital adequacy for those banks. The final rule retains the three groups of banks identified in the proposed rule: (i) large or internationally active banks that are required to adopt advanced capital approaches under Basel II (core banks); (ii) banks that voluntarily decide to adopt the advanced approaches (opt-in banks); and (iii) banks that do not adopt the advanced approaches (general banks), and for which the provisions of the final rule are inapplicable. The final rule also retains the proposed rule definition of a core bank as a bank that meets either of two criteria: (i) consolidated assets of \$250 billion or more, or (ii) consolidated total on-balance-sheet foreign exposure of \$10 billion or more. Also, a bank is a core bank if it is a subsidiary of a bank or bank holding company that uses advanced approaches. At this moment, the provisions of the final rule are not applicable to the Corporation.

The agencies expect to publish in the near future a proposed rule that would provide all non-core banks with the option to adopt a standardized approach under Basel II.





**Table of Contents*****FDIC Risk-Based Assessment System***

Under a new rule adopted by the FDIC in November 2006, beginning in 2007, the FDIC placed each institution that it insures in one of four risk categories using a two-step process based first on capital ratios and then on other relevant information (the supervisory group assignment). Beginning in 2007, FDIC insurance premium rates range between 5 and 43 cents per \$100 in accessible deposits. The Corporation experienced significant increases in the insurance assessments as a result of this new assessment system. Future charges could increase or decrease depending on the volume of deposits, upward or downward changes in the regulatory ratings given to the institution upon examination results and or changes in the Corporation's credit ratings.

***FDIC Capital Requirements***

The FDIC has promulgated regulations and a statement of policy regarding the capital adequacy of state-chartered non-member banks like FirstBank. These requirements are substantially similar to those adopted by the Federal Reserve Board regarding bank holding companies, as described above. In addition, FirstBank Florida must comply with similar capital requirements adopted by the OTS.

The regulators require that banks meet a risk-based capital standard. The risk-based capital standard for banks requires the maintenance of total capital (which is defined as Tier I capital and supplementary (Tier 2) capital) to risk-weighted assets of 8%. In determining the amount of risk-weighted assets, weights used (ranging from 0% to 100%) are based on the risks inherent in the type of asset or item. The components of Tier I capital are equivalent to those discussed below under the 3.0% leverage capital standard. The components of supplementary capital include certain perpetual preferred stock, mandatorily convertible securities, subordinated debt and intermediate preferred stock and, generally, allowances for loan and lease losses. Allowance for loan and lease losses includable in supplementary capital is limited to a maximum of 1.25% of risk-weighted assets. Overall, the amount of capital counted toward supplementary capital cannot exceed 100% of core capital.

The capital regulations of the FDIC and the OTS establish a minimum 3.0% Tier I capital to total assets requirement for the most highly-rated state-chartered, non-member banks, with an additional cushion of at least 100 to 200 basis points for all other state-chartered, non-member banks, which effectively will increase the minimum Tier I leverage ratio for such other banks from 4.0% to 5.0% or more. Under these regulations, the highest-rated banks are those that are not anticipating or experiencing significant growth and have well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity and good earnings and, in general, are considered a strong banking organization and are rated composite I under the Uniform Financial Institutions Rating System. Leverage or core capital is defined as the sum of common stockholders' equity including retained earnings, non-cumulative perpetual preferred stock and related surplus, and minority interests in consolidated subsidiaries, minus all intangible assets other than certain qualifying supervisory goodwill and certain purchased mortgage servicing rights.

In August 1995, the FDIC and OTS published a final rule modifying their existing risk-based capital standards to provide for consideration of interest rate risk when assessing the capital adequacy of a bank. Under the final rule, the FDIC must explicitly include a bank's exposure to declines in the economic value of its capital due to changes in interest rates as a factor in evaluating a bank's capital adequacy. In June 1996, the FDIC and OTS adopted a joint policy statement on interest rate risk. Because market conditions, bank structure, and bank activities vary, the agencies concluded that each bank needs to develop its own interest rate risk management program tailored to its needs and circumstances. The policy statement describes prudent principles and practices that are fundamental to sound interest rate risk management, including appropriate board and senior management oversight and a comprehensive risk management process that effectively identifies, measures, monitors and controls such interest rate risk.

Failure to meet capital guidelines could subject an insured bank to a variety of prompt corrective actions and enforcement remedies under the FDIA (as amended by Federal Deposit Insurance Corporation Improvement Act of 1991 ( FDICIA ), and the Riegle Community Development and Regulatory Improvement Act of 1994, including, with respect to an insured bank, the termination of deposit insurance by the FDIC, and certain restrictions on its business. In general terms, undercapitalized depository institutions are prohibited from making any capital

**Table of Contents**

distributions (including dividends), are subject to restrictions on borrowing from the Federal Reserve System, are subject to growth limitations and are required to submit capital restoration plans.

As of December 31, 2007, FirstBank and FirstBank Florida were well-capitalized. A bank's capital category, as determined by applying the prompt corrective action provisions of law, however, may not constitute an accurate representation of the overall financial condition or prospects of the Bank, and should be considered in conjunction with other available information regarding financial condition and results of operations.

Set forth below are the Corporation's, FirstBank's and FirstBank Florida's capital ratios as of December 31, 2007, based on Federal Reserve, FDIC and OTS guidelines, respectively.

|   | <b>Banking Subsidiaries</b> |                  |                | <b>Well-Capitalized<br/>Minimum</b> |
|---|-----------------------------|------------------|----------------|-------------------------------------|
|   | <b>First<br/>BanCorp</b>    | <b>FirstBank</b> | <b>Florida</b> |                                     |
| <b>As of December 31, 2007</b>                                |                             |                  |                |                                     |
| Total capital (Total capital to risk-weighted assets)         | 13.86%                      | 13.23%           | 10.92%         | 10.00%                              |
| Tier 1 capital ratio (Tier 1 capital to risk-weighted assets) | 12.61%                      | 11.98%           | 10.42%         | 6.00%                               |
| Leverage ratio (1)  | 9.29%                       | 8.85%            | 7.79%          | 5.00%                               |

(1) Tier 1 capital to average assets in the case of First BanCorp and FirstBank and Tier 1 Capital to adjusted total assets in the case of FirstBank Florida.

**Activities and Investments**

The activities as principal and equity investments of FDIC-insured, state-chartered banks such as FirstBank are generally limited to those that are permissible for national banks. Under regulations dealing with equity investments, an insured state-chartered bank generally may not directly or indirectly acquire or retain any equity investments of a type, or in an amount, that is not permissible for a national bank.

**Federal Home Loan Bank System**

FirstBank is a member of the Federal Home Loan Bank (FHLB) system. The FHLB system consists of twelve regional Federal Home Loan Banks governed and regulated by the Federal Housing Finance Board (FHFB). The Federal Home Loan Banks serve as reserve or credit facilities for member institutions within their assigned regions. They are funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB system, and they make loans (advances) to members in accordance with policies and procedures established by the FHLB system and the board of directors of each regional FHLB.

FirstBank is a member of the FHLB of New York (FHLB-NY) and as such is required to acquire and hold shares of capital stock in that FHLB for a certain amount, which is calculated in accordance with the requirements set forth in applicable laws and regulations. FirstBank is in compliance with the stock ownership requirements of the FHLB-NY. All loans, advances and other extensions of credit made by the FHLB-NY to FirstBank are secured by a portion of

FirstBank's mortgage loan portfolio, certain other investments and the capital stock of the FHLB-NY held by FirstBank.

FirstBank Florida is a member of the FHLB of Atlanta and is subject to similar requirements as those of FirstBank.

***Ownership and Control***

Because of FirstBank's status as an FDIC-insured bank, as defined in the Bank Holding Company Act, First BanCorp, as the owner of FirstBank's common stock, is subject to certain restrictions and disclosure obligations under various federal laws, including the Bank Holding Company Act and the Change in Bank Control Act (the "CBCA"). Regulations pursuant to the Bank Holding Company Act generally require prior Federal Reserve Board approval for an acquisition of control of an insured institution (as defined in the Act) or holding company thereof by

**Table of Contents**

any person (or persons acting in concert). Control is deemed to exist if, among other things, a person (or persons acting in concert) acquires more than 25% of any class of voting stock of an insured institution or holding company thereof. Under the CBCA, control is presumed to exist subject to rebuttal if a person (or persons acting in concert) acquires more than 10% of any class of voting stock and either (i) the corporation has registered securities under Section 12 of the Securities Exchange Act of 1934, or (ii) no person will own, control or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction. The concept of acting in concert is very broad and also is subject to certain rebuttable presumptions, including among others, that relatives, business partners, management officials, affiliates and others are presumed to be acting in concert with each other and their businesses. The regulations of the FDIC and the OTS implementing the CBCA are generally similar to those described above.

The Puerto Rico Banking Law requires the approval of the OCIF for changes in control of a Puerto Rico bank. See Puerto Rico Banking Law.

***Cross-Guarantees***

Under the FDIA, a depository institution (which term includes both banks and savings associations), the deposits of which are insured by the FDIC, can be held liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to any commonly controlled FDIC-insured depository institution in danger of default. Default is defined generally as the appointment of a conservator or a receiver and in danger of default is defined generally as the existence of certain conditions indicating that a default is likely to occur in the absence of regulatory assistance. In some circumstances (depending upon the amount of the loss or anticipated loss suffered by the FDIC), cross-guarantee liability may result in the ultimate failure or insolvency of one or more insured depository institutions liable to the FDIC, and any obligations of that bank to its parent corporation are subordinated to the subsidiary bank's cross-guarantee liability with respect to commonly controlled insured depository institutions. FirstBank and FirstBank Florida are currently the only FDIC-insured depository institutions controlled by the Corporation and therefore subject to this guaranty provision.

***Standards for Safety and Soundness***

The FDIA, as amended by FDICIA and the Riegle Community Development and Regulatory Improvement Act of 1994, requires the FDIC and the other federal bank regulatory agencies to prescribe standards of safety and soundness, by regulations or guidelines, relating generally to operations and management, asset growth, asset quality, earnings, stock valuation, and compensation. The FDIC and the other federal bank regulatory agencies adopted, effective August 9, 1995, a set of guidelines prescribing safety and soundness standards pursuant to FDIA, as amended. The guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal shareholder.

***Brokered Deposits***

FDIC regulations adopted under the FDIA govern the receipt of brokered deposits by banks. Well-capitalized institutions are not subject to limitations on brokered deposits, while adequately-capitalized institutions are able to accept, renew or rollover brokered deposits only with a waiver from the FDIC and subject to certain restrictions on the interest paid on such deposits. Undercapitalized institutions are not permitted to accept brokered deposits. As of December 31, 2007, FirstBank was a well-capitalized institution and was therefore not subject to these limitations on brokered deposits.

**Table of Contents*****Puerto Rico Banking Law***

As a commercial bank organized under the laws of the Commonwealth, FirstBank is subject to supervision, examination and regulation by the Commonwealth of Puerto Rico Commissioner of Financial Institutions ( Commissioner ) pursuant to the Puerto Rico Banking Law of 1933, as amended (the Banking Law ). The Banking Law contains provisions governing the incorporation and organization, rights and responsibilities of directors, officers and stockholders as well as the corporate powers, lending limitations, capital requirements, investment requirements and other aspects of FirstBank and its affairs. In addition, the Commissioner is given extensive rule-making power and administrative discretion under the Banking Law.

The Banking Law authorizes Puerto Rico commercial banks to conduct certain financial and related activities directly or through subsidiaries, including the leasing of personal property and the operation of a small loan corporation.

The Banking Law requires every bank to maintain a legal reserve which shall not be less than twenty percent (20%) of its demand liabilities, except government deposits (federal, state and municipal), that are secured by actual collateral. The reserve is required to be composed of any of the following securities or combination thereof: (1) legal tender of the United States; (2) checks on banks or trust companies located in any part of Puerto Rico that are to be presented for collection during the day following the day on which they are received, (3) money deposited in other banks provided said deposits are authorized by the Commissioner, subject to immediate collection; (4) federal funds sold to any Federal Reserve Bank and securities purchased under agreements to resell executed by the bank with such funds that are subject to be repaid to the bank on or before the close of the next business day; and (5) any other asset that the Commissioner identifies from time to time.

The Banking Law permits Puerto Rico commercial banks to make loans to any one person, firm, partnership or corporation, up to an aggregate amount of fifteen percent (15%) of the sum of: (i) the bank's paid-in capital; (ii) the bank's reserve fund; (iii) 50% of the bank's retained earnings; subject to certain limitations, and (iv) any other components that the Commissioner may determine from time to time. If such loans are secured by collateral worth at least twenty five percent (25%) more than the amount of the loan, the aggregate maximum amount may reach one third (33.33%) of the sum of the bank's paid-in capital, reserve fund, 50% of retained earnings and such other components that the Commissioner may determine from time to time. There are no restrictions under the Banking Law on the amount of loans that are wholly secured by bonds, securities and other evidence of indebtedness of the Government of the United States, or of the Commonwealth of Puerto Rico, or by bonds, not in default, of municipalities or instrumentalities of the Commonwealth of Puerto Rico. The revised classification of the mortgage-related transactions as secured commercial loans to local financial institutions included in the Corporation's restatement of previously issued financial statements (Form 10-K/A 2004), caused the mortgage-related transactions to be treated as two secured commercial loans in excess of the lending limitations imposed by the Banking Law. In this regard, FirstBank received a ruling from the Commissioner that results in FirstBank being considered in continued compliance with the lending limitations. The Puerto Rico Banking Law authorizes the Commissioner to determine other components which may be considered for purposes of establishing its lending limit, which components may lay outside the traditional elements mentioned in Section 17. After consideration of other components, the Commissioner authorized the Corporation to retain the secured loans to Doral and R&G as it believed that these loans were secured by sufficient collateral to diversify, disperse and significantly diffuse the risks connected to such loans thereby satisfying the safety and soundness considerations mandated by Section 28 of the Puerto Rico Banking Law.

The Banking Law prohibits Puerto Rico commercial banks from making loans secured by their own stock, and from purchasing their own stock, unless such purchase is made pursuant to a stock repurchase program approved by the Commissioner or is necessary to prevent losses because of a debt previously contracted in good faith. The stock purchased by the Puerto Rico commercial bank must be sold by the bank in a public or private sale within one year from the date of purchase.

The Banking Law provides that no officers, directors, agents or employees of a Puerto Rico commercial bank may serve or discharge a position of officer, director, agent or employee of another Puerto Rico commercial bank, financial corporation, savings and loan association, trust corporation, corporation engaged in granting mortgage loans or any other institution engaged in the money lending business in Puerto Rico. This prohibition is not applicable to the

affiliates of a Puerto Rico commercial bank.

**Table of Contents**

The Banking Law requires that Puerto Rico commercial banks prepare each year a balance summary of their operations, and submit such balance summary for approval at a regular meeting of stockholders, together with an explanatory report thereon. The Banking Law also requires that at least ten percent (10%) of the yearly net income of a Puerto Rico commercial bank be credited annually to a reserve fund. This credit is required to be done every year until such reserve fund shall be equal to the total paid-in-capital of the bank.

The Banking Law also provides that when the expenditures of a Puerto Rico commercial bank are greater than receipts, the excess of the expenditures over receipts shall be charged against the undistributed profits of the bank, and the balance, if any, shall be charged against the reserve fund, as a reduction thereof. If there is no reserve fund sufficient to cover such balance in whole or in part, the outstanding amount shall be charged against the capital account and no dividend shall be declared until said capital has been restored to its original amount and the reserve fund to twenty percent (20%) of the original capital.

The Banking Law requires the prior approval of the Commissioner with respect to a transfer of capital stock of a bank that results in a change of control of the bank. Under the Banking Law, a change of control is presumed to occur if a person or a group of persons acting in concert, directly or indirectly, acquire more than 5% of the outstanding voting capital stock of the bank. The Commissioner has interpreted the restrictions of the Banking Law as applying to acquisitions of voting securities of entities controlling a bank, such as a bank holding company. Under the Banking Law, the determination of the Commissioner whether to approve a change of control filing is final and non-appealable.

The Finance Board, which is composed of the Commissioner, the Secretary of the Treasury, the Secretary of Commerce, the Secretary of Consumer Affairs, the President of the Economic Development Bank, the President of the Government Development Bank, and the President of the Planning Board, has the authority to regulate the maximum interest rates and finance charges that may be charged on loans to individuals and unincorporated businesses in Puerto Rico. The current regulations of the Finance Board provide that the applicable interest rate on loans to individuals and unincorporated businesses, including real estate development loans but excluding certain other personal and commercial loans secured by mortgages on real estate properties, is to be determined by free competition. Accordingly, the regulations do not set a maximum rate for charges on retail installment sales contracts and for credit card purchases and set aside previous regulations which regulated these maximum finance charges. Furthermore, there is no maximum rate set for installment sales contracts involving motor vehicles, commercial, agricultural and industrial equipment, commercial electric appliances and insurance premiums.

***International Banking Act of Puerto Rico ( IBE Act )***

The business and operations of First BanCorp IBE, FirstBank IBE and FirstBank Overseas Corporation are subject to supervision and regulation by the Commissioner. Under the IBE Act, certain sales, encumbrances, assignments, mergers, exchanges or transfers of shares, interests or participation(s) in the capital of an international banking entity (an IBE ) may not be initiated without the prior approval of the Commissioner. The IBE Act and the regulations issued thereunder by the Commissioner (the IBE Regulations ) limit the business activities that may be carried out by an IBE. Such activities are limited in part to persons and assets located outside of Puerto Rico.

Pursuant to the IBE Act and the IBE Regulations, each of First BanCorp IBE, FirstBank IBE and FirstBank Overseas Corporation must maintain books and records of all its transactions in the ordinary course of business. First BanCorp IBE, FirstBank IBE and FirstBank Overseas Corporation are also required thereunder to submit to the Commissioner quarterly and annual reports of their financial condition and results of operations, including annual audited financial statements.

The IBE Act empowers the Commissioner to revoke or suspend, after notice and hearing, a license issued thereunder if, among other things, the IBE fails to comply with the IBE Act, the IBE Regulations or the terms of its license, or if the Commissioner finds that the business or affairs of the IBE are conducted in a manner that is not consistent with the public interest.

***Puerto Rico Income Taxes***

Under the Puerto Rico Internal Revenue Code of 1994 (the Code ), all companies are treated as separate taxable entities and are not entitled to file consolidated tax returns. The Corporation, and each of its subsidiaries are





**Table of Contents**

subject to a maximum statutory corporate income tax rate of 39% or an alternative minimum tax ( AMT ) on income earned from all sources, whichever is higher. The excess of AMT over regular income tax paid in any one year may be used to offset regular income tax in future years, subject to certain limitations. The Code provides for a dividend received deduction of 100% on dividends received from wholly owned subsidiaries subject to income taxation in Puerto Rico and 85% on dividends received from other taxable domestic corporations.

In computing the interest expense deduction, the Corporation's interest deduction will be reduced in the same proportion that the average exempt assets bear to the average total assets. Therefore, to the extent that the Corporation holds certain investments and loans which are exempt from Puerto Rico income taxation, part of its interest expense will be disallowed for tax purposes.

The Corporation has maintained an effective tax rate lower than the maximum statutory tax rate of 39% as of December 31, 2007, mainly by investing in government obligations and mortgage-backed securities exempt from U.S. and Puerto Rico income tax combined with income from the IBE units of the Corporation and the Bank and the Bank's subsidiary, FirstBank Overseas Corporation. The IBE, and FirstBank Overseas Corporation were created under the IBE Act, which provides for Puerto Rico tax exemption on net income derived by IBEs operating in Puerto Rico. Pursuant to the provisions of Act No. 13 of January 8, 2004, the IBE Act was amended to impose income tax at regular rates on IBEs that operate as units of a bank, to the extent that the IBEs net income exceeds 25% of the bank's total net taxable income (including net income generated by the IBE unit) for taxable years that commenced on July 1, 2005, and thereafter. These amendments apply only to IBEs that operate as units of a bank; they do not impose income tax on an IBE that operates as a subsidiary of a bank.

Act 41 of August 1, 2005 amended the Code by imposing a temporary additional tax of 2.5% on net taxable income for all corporations. This temporary tax effectively increased the statutory tax rate from 39% to 41.5%. The Act became effective for taxable years commencing after December 31, 2004 and ending on or before December 31, 2006 and therefore was effective for the 2005 and 2006 taxable years with a retroactive effect to January 1, 2005.

Act 89 of May 13, 2006 amended the Puerto Rico Internal Revenue Code by imposing a 2% additional income tax on income subject to regular taxes of all corporations operating pursuant to Act 55 of 1933 (The Puerto Rico Banking Act). Act 89 was effective for the taxable year that commenced after December 31, 2005 and on or before December 31, 2006 and, therefore, increased the statutory tax for the 2006 taxable year to 43.5%. The statutory tax reverted to 39% for taxable years commencing after December 31, 2006.

***United States Income Taxes***

The Corporation is also subject to federal income tax on its income from sources within the United States and on any item of income that is, or is considered to be, effectively connected with the active conduct of a trade or business within the United States. The U.S. Internal Revenue Code provides for tax exemption of portfolio interest received by a foreign corporation from sources within the United States; therefore, the Corporation is not subject to federal income tax on certain U.S. investments which qualify under the term portfolio interest .

***Insurance Operations Regulation***

FirstBank Insurance Agency is registered as an insurance agency with the Insurance Commissioner of Puerto Rico and is subject to regulations issued by the Insurance Commissioner relating to, among other things, licensing of employees, sales, solicitation and advertising practices, and to the FED as to certain consumer protection provisions mandated by the Gramm-Leach-Bliley Act and its implementing regulations.

***Community Reinvestment***

Under the Community Reinvestment Act ( CRA ), federally insured banks have a continuing and affirmative obligation to meet the credit needs of their entire community, including low- and moderate-income residents, consistent with their safe and sound operation. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the type of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the federal supervisory agencies, as part of the general examination of supervised banks, to assess the bank's record of

**Table of Contents**

meeting the credit needs of its community, assign a performance rating, and take such record and rating into account in their evaluation of certain applications by such bank. The CRA also requires all institutions to make public disclosure of their CRA ratings. FirstBank and FirstBank Florida received a satisfactory CRA rating in their most recent examinations by the FDIC and the OTS, respectively.

***Mortgage Banking Operations***

FirstBank is subject to the rules and regulations of the FHA, VA, FNMA, FHLMC, HUD and GNMA with respect to originating, processing, selling and servicing mortgage loans and the issuance and sale of mortgage-backed securities. Those rules and regulations, among other things, prohibit discrimination and establish underwriting guidelines that include provisions for inspections and appraisals, require credit reports on prospective borrowers and fix maximum loan amounts, and with respect to VA loans, fix maximum interest rates. Moreover, lenders such as FirstBank are required annually to submit to FHA, VA, FNMA, FHLMC, GNMA and HUD audited financial statements, and each regulatory entity has its own financial requirements. FirstBank's affairs are also subject to supervision and examination by FHA, VA, FNMA, FHLMC, GNMA and HUD at all times to assure compliance with the applicable regulations, policies and procedures. Mortgage origination activities are subject to, among others, the Equal Credit Opportunity Act, Federal Truth-in-Lending Act, and the Real Estate Settlement Procedures Act and the regulations promulgated thereunder which, among other things, prohibit discrimination and require the disclosure of certain basic information to mortgagors concerning credit terms and settlement costs. FirstBank is licensed by the Commissioner under the Puerto Rico Mortgage Banking Law, and as such is subject to regulation by the Commissioner, with respect to, among other things, licensing requirements and establishment of maximum origination fees on certain types of mortgage loan products.

Section 5 of the Puerto Rico Mortgage Banking Law requires the prior approval of the Commissioner for the acquisition of control of any mortgage banking institution licensed under such law. For purposes of the Puerto Rico Mortgage Banking Law, the term control means the power to direct or influence decisively, directly or indirectly, the management or policies of a mortgage banking institution. The Puerto Rico Mortgage Banking Law provides that a transaction that results in the holding of less than 10% of the outstanding voting securities of a mortgage banking institution shall not be considered a change in control.

***Recent Legislation***

Refer to Recent Significant Events Recent Puerto Rico Legislation above for information regarding significant legislation approved during 2007 that may have an effect in the Corporation's operations and financial results.

**Item 1A. Risk Factors**

Certain risk factors that may affect the Corporation's future results of operations are discussed below.

**Risks Relating to the Corporation's Business*****Banking regulators could take adverse action against the Corporation***

The Corporation is subject to supervision and regulation by the FED. The Corporation is a bank holding company that qualifies as a financial holding corporation. As such, the Corporation is permitted to engage in a broader spectrum of activities than those permitted to bank holding companies that are not financial holding companies. To continue to qualify as a financial holding corporation, each of the Corporation's banking subsidiaries must continue to qualify as well-capitalized and well-managed. As of December 31, 2007, the Corporation and its banking subsidiaries continue to satisfy all applicable capital guidelines. This, however, does not prevent banking regulators from taking adverse actions against the Corporation as a result of the Consent Order or related internal control matters. If the Corporation were not to continue to qualify as a financial holding corporation, it might be

**Table of Contents**

required to discontinue certain activities and may be prohibited from engaging in new activities without prior regulatory approval.

The FED, in the performance of its supervisory and enforcement duties, has significant discretion and power to initiate enforcement actions for violations of laws and regulations and unsafe or unsound practices. Failure of the Corporation to remain in compliance with the terms of the Consent Order could result in the imposition of additional cease and desist orders and/or in money penalties.

***Downgrades in the Corporation's credit ratings could potentially increase the cost of borrowing funds***

The credit ratings of the Corporation and First Bank and their outstanding securities are subject to downgrades as a result of, among other things, their results and operations. For example, following the Corporation's announcement on October 21, 2005 that the SEC had issued a formal order of investigation, the major rating agencies downgraded the Corporation's and FirstBank's ratings in a series of actions. In response to this announcement, Fitch Ratings, Ltd. lowered the Corporation's long-term senior debt rating from BBB- to BB and placed the rating on negative outlook after removing it from Rating Watch Negative. Standard & Poors lowered the long-term senior debt and counterparty rating of FirstBank from BBB- to BB+ and placed the rating on stable outlook after removing it from Credit Watch with negative implications and Moody's Investor Service lowered FirstBank's long-term senior debt rating from Baa3 to Ba1 and placed the rating on negative outlook. Any future downgrades may adversely affect the Corporation's and FirstBank's ability to access capital and result in more stringent covenants and higher interest rates under the terms of any future indebtedness.

These debt and financial strength ratings are current opinions of the rating agencies. As such, they may be changed, suspended or withdrawn at any time by the rating agencies as a result of changes in, or unavailability of, information or based on other circumstances.

The Corporation's liquidity is contingent upon its ability to obtain external sources of funding to finance its operations. Downgrades in credit ratings can hinder the Corporation's access to external funding and/or cause external funding to be more expensive, which could in turn adversely affect the results of operations.

***Fluctuations in interest rates may impact the Corporation's results of operations***

Increases in interest rates are the primary market risk affecting the Corporation. Interest rates are highly sensitive to many factors, such as governmental monetary policies and domestic and international economic and political conditions that are beyond the control of the Corporation.

From 2004 to 2007, increases in interest rates negatively affected the following areas of the Corporation's business:  
The net interest income;

The value of owned securities, including interest rate swaps; and

the volume of loans originated, particularly mortgage loans.

***Increases in interest rates may reduce net interest income***

Increases in short-term interest rates may reduce net interest income, which is the principal component of the Corporation's earnings. Net interest income is the difference between the amount received by the Corporation on its interest-earning assets and the interest paid by the Corporation on its interest-bearing liabilities. When interest rates rise, the Corporation must pay more in interest on its liabilities while the interest earned on its assets does not rise as quickly. This may cause the Corporation's profits to decrease. This adverse impact on earnings is greater when the slope of the yield curve flattens, that is, when short-term interest rates increase more than long-term rates.

**Table of Contents*****Increases in interest rates may reduce the value of holdings of securities***

Fixed-rate securities entered into by the Corporation are generally subject to decreases in market value when interest rates rise, which may require recognition of a loss, (e.g., the identification of other-than-temporary impairment on its available for sale or held to maturity investments portfolio) thereby potentially affecting adversely the results of operations.

***Increases in interest rates may reduce demand for mortgage and other loans***

Higher interest rates increase the cost of mortgage and other loans to consumers and businesses and may reduce demand for such loans, which may negatively impact the Corporation's profits by reducing the amount of loan origination income.

***Decreases in interest rates may increase the exercise of embedded calls in the investment securities portfolio***

Future net interest income could be affected by the Corporation's holding of callable securities. The recent drop in the long end of the yield curve has the effect of increasing the probability of the exercise of embedded calls in the approximately \$2.1 billion U.S. Agency securities portfolio that if substituted with new lower-yield investments may negatively impact the Corporation's interest income.

***Decreases in interest rates may reduce net interest income due to the current unprecedented re-pricing mismatch of assets and liabilities tied to short-term interest rates (Basis Risk)***

Basis risk occurs when market rates for different financial instruments, or the indices used to price assets and liabilities, change at different times or by different amounts. Recent liquidity pressures affecting the U.S. financial markets have caused a wider than historical spread between brokered CDs costs and LIBOR rates for similar terms. This in turn, is preventing the Corporation from capturing the full benefit of recent drops in interest rates as the Corporation's loan portfolio funded by LIBOR-based brokered CDs continues to maintain the same historical spread to short-term LIBOR rates. To the extent that such pressures fail to subside in the near future, the margin between the Corporation's LIBOR-based assets and LIBOR-based liabilities may compress and adversely affect net interest income.

***The Corporation is subject to default risk on loans, which may adversely affect its results***

The Corporation is subject to the risk of loss from loan defaults and foreclosures with respect to the loans it originates. The Corporation establishes a provision for loan losses, which leads to reductions in its income from operations, in order to maintain its allowance for inherent loan losses at a level which its management deems to be appropriate based upon an assessment of the quality of its loan portfolio. Although the Corporation's management utilizes its best judgment in providing for loan losses, there can be no assurance that management has accurately estimated the level of inherent loan losses or that the Corporation will not have to increase its provision for loan losses in the future as a result of future increases in non performing loans or for other reasons beyond its control. Any such increases in the Corporation's provision for loan losses or any loan losses in excess of its provision for loan losses would have an adverse effect on the Corporation's future financial condition and results of operations. Given the difficulties of the Corporation's largest borrowers, Doral and R&G Financial, the Corporation can give no assurance that these borrowers will continue to repay their secured loans on a timely basis or that the Corporation will continue to be able to accurately assess any risk of loss from the loans to these financial institutions.

***The Corporation is subject to greater credit risk with respect to its portfolio of construction and commercial loans***

The Corporation invests in construction loans and mortgage loans secured by income-producing residential buildings and commercial properties through its banking subsidiaries. These loans are subject to greater credit risk than consumer and residential mortgage loans. These types of loans involve greater credit risk than residential mortgage loans because they are larger in size, concentrate more risk in a single borrower and are generally more sensitive to economic conditions. The properties securing these loans are also harder to dispose of in foreclosure.

***Changes in collateral valuation for properties located in stagnant or distressed economies may require increased reserves***

Substantially all of the loan portfolio of the Corporation is located within the boundaries of the U.S. economy. Whether the collateral is located in Puerto Rico, the U.S. Virgin Islands or the U.S. mainland, the performance of the Corporation's loan portfolio and the collateral value backing the transactions are dependent upon the performance of and conditions within each specific area real estate market. Recent economic reports related to the real estate market

in Puerto Rico indicate that certain pockets of the real estate market are subject to readjustments in value driven not by demand but more by the purchasing power of the consumers and general economic conditions. In South Florida we are seeing the negative impact associated with low absorption rates and property value adjustments due to overbuilding. A significant decline in collateral valuations for collateral dependent loans may require increases in

**Table of Contents**

the Corporation's specific provision for loan losses and an increase in the general valuation allowance. Any such increase would have an adverse effect on the Corporation's future financial condition and results of operations.

***The Corporation's business concentration in Puerto Rico imposes risks***

The Corporation conducts its operations in a geographically concentrated area, as its main market is Puerto Rico. This imposes risks from lack of diversification in the geographical portfolio. The Corporation's financial condition and results of operations are highly dependent on the economic conditions of Puerto Rico, where adverse political or economic developments, natural disasters, etc., could affect the volume of loan originations, increase the level of nonperforming assets, increase the rate of foreclosure losses on loans, and reduce the value of the Corporation's loans and loan servicing portfolio.

These factors could materially and adversely affect the Corporation's financial condition and results of operations. The Corporation had substantial secured loans to two local financial institutions, Doral and R&G, in the aggregate amount of \$624.6 million and \$932.0 million as of December 31, 2007 and 2006, respectively.

***First BanCorp's credit quality may be adversely affected by Puerto Rico's current economic condition***

Beginning in 2005 and continuing through 2007, a number of key economic indicators suggested that the economy of Puerto Rico was slowing down.

Construction remained weak during 2007, as the combination of rising interest rates, the Commonwealth's fiscal situation and decreasing public investment in construction projects affected the sector. During the period from January to November of the calendar year 2007, cement production, a real indicator of construction activity, declined by 11.7% as compared to the same period in 2006. As of September 2007, exports decreased by 11.7%, while imports decreased by 8.9%, a negative trade, which continues since the first negative trade balance of the last decade was registered in November 2006. Tourism activity has also declined during fiscal year 2007. Total hotel registrations for the fiscal year 2007 declined 5.1% as compared to the fiscal year 2006. During 2007 new vehicle sales decreased by 13%, the lowest since 1993. In 2007, average employment declined by 1.27% while the average number of unemployed increased by 3.30%; the unemployment rate increased to 11.2% when compared to the December 2006 unemployment rate of 10.2%.

In general, the Puerto Rico economy continued its trend of decreasing growth, primarily due to weaker manufacturing, softer consumption and decreased government investment in construction.

The above economic concerns and uncertainty in the private and public sectors may also have an adverse effect on the credit quality of the Corporation's loan portfolios, as delinquency rates are expected to increase in the short-term, until the economy stabilizes. Also, a potential reduction in consumer spending may also impact growth in other interest and non-interest revenue sources of the Corporation.

***Rating downgrades on the Government of Puerto Rico's debt obligations may affect the Corporation's credit exposure***

Even though Puerto Rico's economy is closely integrated to that of the U.S. mainland and its government and many of its instrumentalities are investment-grade rated borrowers in the U.S. capital markets, the current fiscal situation of the Government of Puerto Rico has led nationally recognized rating agencies to downgrade its debt obligations.

In May 2006, Moody's Investors Service downgraded the Government's general obligation bond rating to Baa3 from Baa2, and put the credit on "watch list" for possible further downgrades. The Commonwealth's appropriation bonds and some of the subordinated revenue bonds were also downgraded by one notch and are now rated below investment grade at Ba1. Moody's commented that this action reflects the Government's strained financial condition, the ongoing political conflict and lack of agreement regarding the measures necessary to end the

**Table of Contents**

government's multi-year trend of financial deterioration. Standard & Poor's Rating Services still rates the Government's general obligations two notches above junk at BBB, and the Commonwealth's appropriation bonds and some of the subordinated revenue bonds BBB-, still investment-grade rated.

In July 2006, S&P and Moody's affirmed their credit ratings on the Commonwealth debt, and removed the debt from their respective watch lists, thus reducing the probability of a downgrade in the near future. These actions resulted after the Government approved the budget for the 2007 fiscal year, which runs from July 2006 through June 2007 and included the establishment of a new sales tax. Revenues from the sales tax are to be dedicated primarily to fund the government's operating expenses, and, to a lesser extent, to repay government debt and fund local municipal governments.

Both rating agencies maintained the negative outlook for the Puerto Rico general obligation bonds. Factors such as the government's ability to implement meaningful steps to curb operating expenditures, improve managerial and budgetary controls, and eliminate the government's reliance on operating budget loans from the Government Development Bank of Puerto Rico will be key determinants of future rating improvement and restoration of a stable long-term outlook. A repeat of an impasse on future fiscal year Commonwealth budget agreements could result in negative ratings actions from the rating agencies.

It is uncertain how the financial markets may react to any potential future ratings downgrade in Puerto Rico's debt obligations. However, the fallout from the recent budgetary crisis and a possible ratings downgrade could adversely affect the value of Puerto Rico's Government obligations.

***A prolonged economic slowdown or the decline in the real estate market in the U.S. mainland could harm the results of operations***

The residential mortgage loan origination business has historically been cyclical, enjoying periods of strong growth and profitability followed by periods of shrinking volumes and industry-wide losses. The market for residential mortgage loan originations is currently in decline and this trend could also reduce the level of mortgage loans the Corporation may produce in the future and adversely impact our business. During periods of rising interest rates, refinancing originations for many mortgage products tend to decrease as the economic incentives for borrowers to refinance their existing mortgage loans are reduced. In addition, the residential mortgage loan origination business is impacted by home values. Over the past eighteen months, residential real estate values in many areas of the U.S. mainland have decreased greatly, which has led to lower volumes and higher losses across the industry, adversely impacting our mortgage business.

The actual rates of delinquencies, foreclosures and losses on loans could be higher during economic slowdowns. Rising unemployment, higher interest rates or declines in housing prices tend to have a greater negative effect on the ability of borrowers to repay their mortgage loans. Any sustained period of increased delinquencies, foreclosures or losses could harm the Corporation's ability to sell loans, the prices the Corporation receives for loans, the values of mortgage loans held-for-sale or residual interests in securitizations, which could harm the Corporation's financial condition and results of operations. In addition, any material decline in real estate values would weaken the collateral loan-to-value ratios and increase the possibility of loss if a borrower defaults. In such event, the Corporation will be subject to the risk of loss on such mortgage asset arising from borrower defaults to the extent not covered by third-party credit enhancement.

***Changes in regulations and legislation could have a financial impact on First BanCorp***

As a financial institution, the Corporation is subject to the legislative and rulemaking authority of various regulatory and legislative bodies. Any change in regulations and/or legislation, whether in the United States or Puerto Rico, could have a financial impact on the results of operations of the Corporation.



**Table of Contents**

***Controversy surrounding parcels of land underlying a significant construction loan of the Corporation, Paseo Caribe, could have a significant effect on the Corporation's results of operations***

*- Litigation in connection with the Opinion of the Secretary of Justice of Puerto Rico*

The Corporation announced in a press release dated December 11, 2007, that the Secretary of Justice of Puerto Rico issued an opinion stating that various of the parcels of land upon which construction of the Paseo Caribe project is being conducted are of public domain and therefore not eligible for sale to private parties. The Corporation had further stated that, as a result of this opinion, First BanCorp (through its banking subsidiary FirstBank) had filed a declaratory judgment lawsuit in San Juan Superior Court requesting that the court declare that the tracts of land in question never constituted public domain property. After the filing of this action the Superior Court has held two hearings in which it has heard oral arguments and received briefs and evidence from all parties involved, including First BanCorp, the Department of Justice, the Paseo Caribe developer, the Hotel Development Corporation and Hilton Hotels. On February 8, 2008 the San Juan Superior Court issued its judgment ruling that the properties in question are not of public domain but legally belong to Paseo Caribe. This judgment will be followed by an appellate process until the Supreme Court of Puerto Rico, the court of last resort in Puerto Rico, renders its final adjudications on this matter. The Corporation intends to pursue certain legal processes in order to expedite the final resolution of this matter by the Supreme Court of Puerto Rico.

In terms of the construction, following the December 11, 2007 decision by the Secretary of Justice, the Regulations and Permits Board ("ARPE") issued a 60 days temporary suspension of the construction permits. The temporary suspension of the construction permits expired on February 26, 2008, but upon such expiration ARPE followed with another order extending the suspension of the permits for an additional 60 days. On February 28, 2008, the Puerto Rico Supreme Court revoked ARPE's determination thus allowing the continuation of the construction of the Paseo Caribe project.

*- Details on the Financing of the Project*

The Corporation has approximately \$114 million of financing outstanding with Paseo Caribe allocated to the various construction and development phases within the overall project. As it relates to the parcels of land that the Secretary of Justice deems of public domain, the amount of loans outstanding is approximately \$47 million. The loans are current as of the date of the filing of this Annual Report on Form 10-K. Additionally, the mortgage liens on the tracts of land securing the Corporation's loans are insured with title insurance policies purchased at the time of the closing of the financing. The title insurance covers any defect in title that includes title to the property being vested differently than stated in the policy, the title becoming non-marketable, or the invalidity or enforceability of the mortgage lien.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

As of December 31, 2007, First BanCorp owned the following three main offices located in Puerto Rico:

Main offices:

- **Headquarters** Located at First Federal Building, 1519 Ponce de León Avenue, Santurce, Puerto Rico, a 16 story office building. Approximately 60% of the building, an underground three level parking lot and an adjacent parking lot are owned by the Corporation.
- **EDP & Operations Center** A five-story structure located at 1506 Ponce de León Avenue, Santurce, Puerto Rico. These facilities are fully occupied by the Corporation.
- **Consumer Lending Center** A three-story building with a three-level parking lot located at 876 Muñoz Rivera Avenue, corner Jesús T. Piñero Avenue, Hato Rey, Puerto Rico. These facilities are fully occupied by the Corporation. In addition, during 2006, First BanCorp purchased the following office located in Puerto Rico:

In addition, during 2006, First BanCorp purchased a building located on 1130 Muñoz Rivera Avenue, Hato Rey, Puerto Rico. These facilities are being remodeled and expanded to accommodate branch operations, data processing,



**Table of Contents**

administrative and certain headquarter offices. FirstBank expects to commence occupancy as soon as practicable but not earlier than 2009.

In addition, the Corporation owned 29 branch and office premises and auto lots and leased 172 branch premises, loan and office centers and other facilities. All of these premises are located in Puerto Rico, Florida and in the U.S. and British Virgin Islands. Management believes that the Corporation's properties are well maintained and are suitable for the Corporation's business as presently conducted.

**Item 3. Legal Proceedings**

During 2007, the Corporation continued to be subject to various legal proceedings, including regulatory investigations and civil litigation, as a result of the restatement of the 2004 financial information. For information on these proceedings, please refer to Note 32 to the audited financial statements included in Item 8, Financial Statements and Supplementary data, of this Annual Report on Form 10-K and to Recent Significant Events, above.

Additionally, the Corporation and its subsidiaries are defendants in various lawsuits arising in the ordinary course of business. In the opinion of the Corporation's management, except as described in Note 32 to the audited financial statements included in Item 8, Financial Statements and Supplementary data, of this Annual Report on Form 10-K and in Recent Significant Events, above, the pending and threatened legal proceedings of which management is aware will not have a material adverse effect on the financial condition or results of operations of the Corporation.

**Item 4. Submission of Matters to a Vote of Security Holders**

First BanCorp held its annual meeting of stockholders on October 31, 2007. The proposals submitted to the meeting and the results of the voting thereon were reported under Part II, Item 4 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007, and are incorporated herein by reference.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities****Market and Holders Information**

The Corporation's common stock is traded on the New York Stock Exchange ( NYSE ) under the symbol FBP. On December 31, 2007, there were 520 holders of record of the Corporation's common stock.

The following table sets forth, for the calendar quarters indicated, the high and low closing sales prices and the cash dividends declared on the Corporation's common stock during such periods. This table reflects the effect of the June 2005 two-for-one stock split on the Corporation's outstanding shares of common stock as of June 15, 2005.

| <b>Quarter ended</b> | <b>High</b> | <b>Low</b> | <b>Last</b> | <b>Dividends Per Share</b> |
|----------------------|-------------|------------|-------------|----------------------------|
| <b>2007:</b>         |             |            |             |                            |
| December             | \$10.16     | \$ 6.15    | \$ 7.29     | \$0.07                     |
| September            | 11.06       | 8.62       | 9.50        | 0.07                       |
| June                 | 13.64       | 10.99      | 10.99       | 0.07                       |
| March                | 13.52       | 9.08       | 13.26       | 0.07                       |
| <b>2006:</b>         |             |            |             |                            |
| December             | \$10.79     | \$ 9.39    | \$ 9.53     | \$0.07                     |
| September            | 11.15       | 8.66       | 11.06       | 0.07                       |
| June                 | 12.22       | 8.90       | 9.30        | 0.07                       |
| March                | 13.15       | 12.20      | 12.36       | 0.07                       |
| <b>2005:</b>         |             |            |             |                            |
| December             | \$15.56     | \$10.61    | \$12.41     | \$0.07                     |
| September            | 26.07       | 16.50      | 16.92       | 0.07                       |
| June                 | 21.31       | 17.31      | 20.08       | 0.07                       |
| March                | 32.26       | 20.78      | 21.13       | 0.07                       |

First BanCorp has five outstanding series of non convertible preferred stock: 7.125% non-cumulative perpetual monthly income preferred stock, Series A (liquidation preference \$25 per share); 8.35% non-cumulative perpetual monthly income preferred stock, Series B (liquidation preference \$25 per share); 7.40% non-cumulative perpetual monthly income preferred stock, Series C (liquidation preference \$25 per share); 7.25% non-cumulative perpetual monthly income preferred stock, Series D (liquidation preference \$25 per share.); and 7.00% non-cumulative perpetual monthly income preferred stock, Series E (liquidation preference \$25 per share) (collectively Preferred Stock ), which trade on the NYSE.

The Series A, B, C, D, and E Preferred Stock rank on parity with respect to dividend rights and rights upon liquidation, winding up or dissolution. Holders of each series of preferred stock will be entitled to receive cash dividends, when, and if declared by the board of directors of First BanCorp out of funds legally available for dividends.

The terms of the Corporation's preferred stock do not permit the Corporation to declare, set apart or pay any dividend or make any other distribution of assets on, or redeem, purchase, set apart or otherwise acquire shares of common stock or of any other class of stock of First BanCorp ranking junior to the preferred stock, unless all accrued and unpaid dividends on the preferred stock and any parity stock, for the twelve monthly dividend periods ending on the immediately preceding dividend payment date, shall have been paid or are paid contemporaneously; the full monthly dividend on the preferred stock and any parity stock for the then current month has been or is contemporaneously declared and paid or declared and set apart for payment; and the Corporation has not defaulted in the payment of the redemption price of any shares of the preferred stock and any parity stock called for redemption. If the Corporation is unable to pay in full the dividends on the preferred stock and on any other shares



**Table of Contents**

of stock of equal rank as to the payment of dividends, all dividends declared upon the preferred stock and any such other shares of stock will be declared pro rata.

The Corporation may not issue shares ranking, as to dividend rights or rights on liquidation, winding up and dissolution, senior to the Series A, B, C, D, and E Preferred Stock, except with the consent of the holders of at least two-thirds of the outstanding aggregate liquidation preference of the Series A, B, C, D, and E Preferred Stock.

**Dividends**

The Corporation has a policy of paying quarterly cash dividends on its outstanding shares of common stock. Accordingly, the Corporation declared a cash dividend of \$0.07 per share for each quarter of 2007, 2006 and 2005. In terms of the dividend payment, the Corporation is confident, based on internal projections, that it will be able to continue paying the current dividend to the common and preferred shareholders during 2008. See the discussion under

Dividend Restrictions under Item 1 for additional information concerning restrictions on the payment of dividends that apply to the Corporation and FirstBank.

First BanCorp did not purchase any of its equity securities during 2007 or 2006.

The Puerto Rico Internal Revenue Code requires the withholding of income tax from dividend income derived by resident U.S. citizens, special partnerships, trusts and estates and non-resident U.S. citizens, custodians, partnerships, and corporations from sources within Puerto Rico.

*Resident U.S. Citizens*

A special tax of 10% is imposed on eligible dividends paid to individuals, special partnerships, trusts, and estates to be applied to all distributions unless the taxpayer specifically elects otherwise. Once this election is made it is irrevocable. However, the taxpayer can elect to include in gross income the eligible distributions received and take a credit for the amount of tax withheld. If the taxpayer does not make this election on the tax return, then he can exclude from gross income the distributions received and reported without claiming the credit for the tax withheld.

*Nonresident U.S. Citizens*

Nonresident U.S. citizens have the right to certain exemptions when a Withholding Tax Exemption Certificate (Form 2732) is properly completed and filed with the Corporation. The Corporation, as withholding agent, is authorized to withhold a tax of 10% only from the excess of the income paid over the applicable tax-exempt amount.

*U.S. Corporations and Partnerships*

Corporations and partnerships not organized under Puerto Rico laws that have not engaged in trade or business in Puerto Rico during the taxable year in which the dividend is paid are subject to the 10% dividend tax withholding. Corporations or partnerships not organized under the laws of Puerto Rico that have engaged in trade or business in Puerto Rico are not subject to the 10% withholding, but they must declare the dividend as gross income on their Puerto Rico income tax return.

For information regarding securities authorized for issuance under First BanCorp's stock-based compensation plans, refer to Part III, Item 11. Executive Compensation in this Annual Report on Form 10-K.

**Table of Contents**

**STOCK PERFORMANCE GRAPH**

*The following Performance Graph shall not be deemed incorporated by reference by any general statement incorporating by reference this Annual Report on Form 10-K into any filing under the Securities Act of 1933, as amended (the Securities Act ) or the Exchange Act, except to the extent that First BanCorp specifically incorporates this information by reference, and shall not otherwise be deemed filed under these Acts.*

The graph below compares the cumulative total stockholder return of First BanCorp during the measurement period with the cumulative total return, assuming reinvestment of dividends, of the S&P 500 Index and the S&P Supercom Banks Index (the Peer Group ). The Performance Graph assumes that \$100 was invested on December 31, 2002 in each of First BanCorp s common stock, the S&P 500 Index and the Peer Group. The comparison in this table are set forth in response to SEC disclosure requirements, and are therefore not intended to forecast or be indicative of future performance of First BanCorp s common stock.

The cumulative total stockholder return was obtained by dividing (i) the cumulative amount of dividends per share, assuming dividend reinvestment since the measurement point, December 31, 2002, plus (ii) the change in the per share price since the measurement date, by the share price at the measurement date.

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth certain selected consolidated financial data for each of the five years in the period ended December 31, 2007. This information should be read in conjunction with the audited consolidated financial statements and the related notes thereto.

(Dollars in thousands except for per share data and financial ratios results)

|   | Year ended December 31, |              |              |              |              |
|---|-------------------------|--------------|--------------|--------------|--------------|
|   | 2007                    | 2006         | 2005         | 2004         | 2003         |
| <b>Condensed Income Statements:</b>                     |                         |              |              |              |              |
| Total interest income                                   | \$ 1,189,247            | \$ 1,288,813 | \$ 1,067,590 | \$ 690,334   | \$ 549,466   |
| Total interest expense                                  | 738,231                 | 845,119      | 635,271      | 292,853      | 297,528      |
| Net interest income                                     | 451,016                 | 443,694      | 432,319      | 397,481      | 251,938      |
| Provision for loan and lease losses                     | 120,610                 | 74,991       | 50,644       | 52,800       | 55,915       |
| Non-interest income                                     | 67,156                  | 31,336       | 63,077       | 59,624       | 106,798      |
| Non-interest expenses                                   | 307,843                 | 287,963      | 315,132      | 180,480      | 164,630      |
| Income before income taxes                              | 89,719                  | 112,076      | 129,620      | 223,825      | 138,191      |
| Income tax expense                                      | 21,583                  | 27,442       | 15,016       | 46,500       | 18,297       |
| Net income  | 68,136                  | 84,634       | 114,604      | 177,325      | 119,894      |
| Net income attributable to common stockholders          | 27,860                  | 44,358       | 74,328       | 137,049      | 89,535       |
| <b>Per Common Share Results (1):</b>                    |                         |              |              |              |              |
| Net income per common share diluted                     | \$ 0.32                 | \$ 0.53      | \$ 0.90      | \$ 1.65      | \$ 1.09      |
| Net income per common share basic                       | \$ 0.32                 | \$ 0.54      | \$ 0.92      | \$ 1.70      | \$ 1.12      |
| Cash dividends declared                                 | \$ 0.28                 | \$ 0.28      | \$ 0.28      | \$ 0.24      | \$ 0.22      |
| Average shares outstanding                              | 86,549                  | 82,835       | 80,847       | 80,419       | 79,988       |
| Average shares outstanding diluted                      | 86,866                  | 83,138       | 82,771       | 83,010       | 81,966       |
| Book value per common share                             | \$ 9.42                 | \$ 8.16      | \$ 8.01      | \$ 8.10      | \$ 6.54      |
| <b>Balance Sheet Data:</b>                              |                         |              |              |              |              |
| Loans and loans held for sale                           | \$11,799,746            | \$11,263,980 | \$12,685,929 | \$ 9,697,994 | \$ 7,041,055 |
| Allowance for loan and lease losses                     | 190,168                 | 158,296      | 147,999      | 141,036      | 126,378      |
| Money market and investment securities                  | 4,811,413               | 5,544,183    | 6,653,924    | 5,699,201    | 5,368,123    |
| Total assets  | 17,186,931              | 17,390,256   | 19,917,651   | 15,637,045   | 12,679,042   |
| Deposits  | 11,034,521              | 11,004,287   | 12,463,752   | 7,912,322    | 6,771,869    |
| Borrowings  | 4,460,006               | 4,662,271    | 5,750,197    | 6,300,573    | 4,634,237    |
| Total common equity                                     | 871,546                 | 679,453      | 647,741      | 654,233      | 523,722      |
| Total equity  | 1,421,646               | 1,229,553    | 1,197,841    | 1,204,333    | 1,073,822    |
| <b>Selected Financial Ratios (In Percent):</b>          |                         |              |              |              |              |
| <b>Profitability:</b>                                   |                         |              |              |              |              |
| Return on Average Assets                                | 0.40                    | 0.44         | 0.64         | 1.30         | 1.15         |
| Return on Average Total Equity                          | 5.14                    | 7.06         | 8.98         | 15.73        | 13.31        |
| Return on Average Common Equity                         | 3.59                    | 6.85         | 10.23        | 23.75        | 18.21        |
| Average Total Equity to Average Total Assets            | 7.70                    | 6.25         | 7.09         | 8.28         | 8.64         |
| Dividend payout ratio                                   | 88.32                   | 52.50        | 30.46        | 14.10        | 19.66        |
| Efficiency ratio (2)                                    | 59.41                   | 60.62        | 63.61        | 39.48        | 45.89        |
| <b>Asset Quality:</b>                                   |                         |              |              |              |              |
| Allowance for loan and lease losses to loans receivable | 1.61                    | 1.41         | 1.17         | 1.46         | 1.80         |
| Net charge-offs to average loans                        | 0.79                    | 0.55         | 0.39         | 0.48         | 0.66         |
| Provision for loan and lease losses to net charge-offs  | 1.36x                   | 1.16x        | 1.12x        | 1.38x        | 1.35x        |

**Other Information:**



|                    |    |      |    |      |    |       |    |       |    |       |
|--------------------|----|------|----|------|----|-------|----|-------|----|-------|
| Common Stock Price | \$ | 7.29 | \$ | 9.53 | \$ | 12.41 | \$ | 31.76 | \$ | 19.78 |
|--------------------|----|------|----|------|----|-------|----|-------|----|-------|

- (1) Amounts presented were recalculated, when applicable, to retroactively consider the effect of the June 30, 2005 two-for-one common stock split.
- (2) Non-interest expense to the sum of net interest income and non-interest income. The denominator includes non-recurring income and changes in the fair value of derivative instruments and financial instruments measured at fair value under SFAS 159.

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations relates to the accompanying consolidated audited financial statements of First BanCorp (the Corporation or First BanCorp) and should be read in conjunction with the audited financial statements and the notes thereto.

**DESCRIPTION OF BUSINESS**

First BanCorp and subsidiaries is a diversified financial holding company headquartered in San Juan, Puerto Rico offering a full range of financial products to consumers and commercial customers through various subsidiaries. First BanCorp is the holding company of FirstBank Puerto Rico (FirstBank or the Bank), Ponce General Corporation (the holding company of FirstBank Florida), Grupo Empresas de Servicios Financieros (d/b/a PR Finance Group) and FirstBank Insurance Agency. Through its wholly-owned subsidiaries, the Corporation operates offices in Puerto Rico, the United States and British Virgin Islands and the State of Florida (USA) specializing in commercial banking, residential mortgage loan originations, finance leases, personal loans, small loans, vehicle rental, insurance agency services and international banking.

The Corporation's results of operations are sensitive to fluctuations in interest rates. Changes in interest rates can materially affect key earnings drivers such as the volume of loan originations, net interest income earned, and gains/losses on investment security holdings. The Corporation manages interest rate risk on an ongoing basis through asset/liability management strategies, which have included the use of various derivative instruments. The Corporation also manages credit risk inherent in its loan portfolios through its underwriting, loan review and collection functions.

**Table of Contents**

**OVERVIEW OF RESULTS OF OPERATIONS**

Net income for the year ended December 31, 2007 amounted to \$68.1 million or \$0.32 per diluted common share, compared to \$84.6 million or \$0.53 per diluted common share for 2006 and \$114.6 million or \$0.90 per diluted common share for 2005.

The Corporation's financial performance for the year ended December 31, 2007, as compared to the year ended December 31, 2006, was principally impacted by the following factors: (1) a higher provision for loan and lease losses, which increased by \$45.6 million to \$120.6 million for year 2007 from \$75.0 million a year ago, driven by increases in the provisions related to the construction loan portfolio of the Corporation's loan agency in Florida (the Miami Agency) and increases in the general reserves allocated to the consumer loan portfolio, (2) a decrease in core net interest income, which on an adjusted tax equivalent basis (for definition and reconciliation of this non-GAAP measure, refer to the *Net Interest Income* discussion below) decreased 10% for 2007 as compared to the previous year from \$529.9 million to \$475.4 million as a result of the continued pressure of the flattening of the yield curve and the decrease in the average volume of interest earning assets, and (3) higher non-interest expenses, which increased by \$19.9 million from \$288.0 million for 2006 to \$307.8 million for the year ended December 31, 2007, resulting primarily from increases in employees' compensation and benefits expense and the deposit insurance premium expense. These factors were partially offset by lower non-cash losses resulting from the valuation of derivative instruments and financial instruments, in particular the negative impact in 2006 financial results of the \$69.7 million unrealized loss related to changes in the fair value of derivative instruments prior to the implementation of the long-haul method of accounting on April 3, 2006. Furthermore, financial results for 2007 were positively impacted by: (1) income of approximately \$15.1 million recognized during 2007 from an agreement reached with insurance carriers and former executives for indemnity of expenses related to the settlement of the class action lawsuit brought against the Corporation (2) a decrease of \$9.3 million in other-than-temporary impairment charges, as compared to 2006, related to equity securities (3) the fluctuation resulting from gains and losses recorded on partial repayments of certain secured commercial loans extended to local financial institutions, and (4) lower professional fees expenses due to the conclusion during 2006 of the Audit Committee's internal investigation that led to the restatement process of the 2004 financial statements. The following table summarizes the effect of the aforementioned factors and other factors that significantly impacted financial results in previous years on net income attributable to common stockholders and earnings per common share for the last three years:

**Table of Contents**

|  | Year ended December 31, |           |           |           |            |           |
|--|-------------------------|-----------|-----------|-----------|------------|-----------|
|  | 2007                    |           | 2006      |           | 2005       |           |
| In thousands, except per common share amounts  | Dollars                 | Per share | Dollars   | Per share | Dollars    | Per share |
| Net income attributable to common stockholders for prior year  | \$ 44,358               | \$ 0.53   | \$ 74,328 | \$ 0.90   | \$ 137,049 | \$ 1.65   |
| Increase (decrease) from changes in:   |                         |           |           |           |            |           |
| Net interest income  | 7,322                   | 0.09      | 11,375    | 0.14      | 34,838     | 0.42      |
| Provision for loan losses  | (45,619)                | (0.55)    | (24,347)  | (0.29)    | 2,156      | 0.03      |
| Net gain (loss) on investments and impairments   | 5,468                   | 0.06      | (20,533)  | (0.25)    | 2,882      | 0.03      |
| Gain (loss) on partial extinguishment and recharacterization of secured commercial loans to local financial institutions | 13,137                  | 0.16      | (10,640)  | (0.13)    |            |           |
| Gain on sale of credit card portfolio  | 2,319                   | 0.03      | 500       | 0.01      | (5,533)    | (0.07)    |
| Insurance reimbursement and other agreements related to a contingency settlement   | 15,075                  | 0.18      |           |           |            |           |
| Other non-interest income  | (179)                   | (0.00)    | (1,068)   | (0.01)    | 6,104      | 0.08      |
| Employees compensation and benefits  | (12,840)                | (0.15)    | (25,445)  | (0.31)    | (19,638)   | (0.24)    |
| Professional fees  | 11,344                  | 0.13      | (18,708)  | (0.23)    | (9,222)    | (0.11)    |
| Deposit insurance premium  | (5,073)                 | (0.06)    | (366)     | (0.00)    | (269)      | (0.00)    |
| Provision for contingencies  |                         |           | 82,750    | 1.00      | (82,750)   | (1.00)    |
| All other operating expenses   | (13,311)                | (0.16)    | (11,062)  | (0.14)    | (22,773)   | (0.27)    |
| Income tax provision   | 5,859                   | 0.07      | (12,426)  | (0.15)    | 31,484     | 0.38      |
| Net income before preferred stock dividends and change in average common shares  | 27,860                  | 0.33      | 44,358    | 0.54      | 74,328     | 0.90      |
| Change in average common shares  |                         | (0.01)    |           | (0.01)    |            |           |
| Net income attributable to common stockholders   | \$ 27,860               | \$ 0.32   | \$ 44,358 | \$ 0.53   | \$ 74,328  | \$ 0.90   |

Net income for the year ended December 31, 2007 was \$68.1 million compared to \$84.6 million and \$114.6 million for the years ended December 31, 2006 and 2005, respectively.

Diluted earnings per common share for the year ended December 31, 2007 amounted to \$0.32 compared to \$0.53 and \$0.90 for the years ended December 31, 2006 and 2005, respectively.

Net interest income for the year ended December 31, 2007 was \$451.0 million compared to \$443.7 million and \$432.3 million for the years ended December 31, 2006 and 2005, respectively. The increase in 2007 was principally due to the effect in the financial results of years 2006 and 2005 of unrealized losses related to changes in the fair value of derivative instruments prior to the implementation of the long-haul method of accounting on April 3, 2006. Previous to the second quarter of 2006, the Corporation recorded changes in the fair value of derivative instruments as non-hedging instruments through operations as part of interest expense. The adoption of fair value hedge accounting in the second quarter of 2006 and the adoption of SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities" in 2007 reduced the accounting volatility that previously resulted from the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. The mark-to-market valuation changes for the year ended December 31, 2007 amounted to a net non-cash loss of \$9.1 million, compared to net non-cash losses of \$58.2 million and \$73.4 million for 2006 and 2005, respectively.

Net interest income on an adjusted tax equivalent basis (for definition and reconciliation of this non-GAAP measure, refer to the *Net Interest Income* discussion below) decreased 10% for 2007, as compared to 2006, (from \$529.9 million in 2006 to \$475.4 million in 2007) and 7% for 2006, as compared to 2005 (from \$566.9 million in 2005 to \$529.9 million in 2006). Adjusted tax equivalent net interest income excludes the effect of mark-to-market valuation changes on derivative instruments and financial liabilities measured at fair value and includes an adjustment that increases interest income on tax-exempt securities and loans by an amount which makes tax-exempt income comparable, on a pre-tax basis, to the Corporation's taxable income. The decrease in adjusted tax equivalent net interest income in 2007, as compared to 2006, was mainly driven by the continued pressure of the flattening of the yield curve during most of 2007 and the decrease in the average volume of interest earning assets primarily attributed to the repayment of approximately \$2.4 billion received from a local financial institution reducing the balance of its secured commercial loan with the Corporation during the latter part of the second quarter of 2006.

Notwithstanding the decrease in net interest income on an adjusted tax equivalent basis in absolute terms, the Corporation has been able to maintain its net interest margin at a relatively stable level. Net interest margin for the year ended December 31, 2007 was 2.83%, compared to 2.84% for the previous year reflecting the effect of

**Table of Contents**

the Corporation's decision to deleverage its balance sheet primarily by the repayment of high-cost borrowings with the proceeds from the sale of lower yielding securities as well as the effect of the steepened yield curve during the last quarter of 2007. During the second half of 2007 the Corporation sold approximately \$556 million and \$400 million of low-yield mortgage-backed securities and U.S. Treasury investments, respectively, and used the proceeds in part to pay down high cost borrowings as they matured. The Corporation reinvested approximately \$566 million in higher yielding U.S. Agency mortgage-backed securities. Also, the Corporation was able to mitigate in part the pressure of the sustained flatness of the yield curve during most of 2007 by the redemption of its \$150 million medium-term note which carried a cost higher than the overall cost of funding.

The decrease in adjusted tax equivalent net interest income for 2006, as compared to 2005, was mainly driven by the reduction in the net interest margin, which on an adjusted tax equivalent basis decreased by 39 basis points due to the flattening of the yield curve, and fluctuations in net interest incurred on interest rate swaps. The decrease in net interest margin for 2006 as compared to 2005 was also attributable to the above noted payment of \$2.4 billion received from a local financial institution during the second quarter of 2006 that significantly reduced its secured commercial loan with the Corporation. Proceeds from the repayment were invested temporarily in short-term investments, reducing the Corporation's average yield on interest-earning assets. The decrease in the interest margin for 2006, as compared to 2005, was partially offset by the increase in the average volume of interest-earning assets of \$1.1 billion attributable to the growth in the construction and residential loan portfolios as well as short-term investments.

The increase in short-term rates during 2007 and 2006 resulted in a change in net interest settlement payments included as part of interest expense. For 2007, the net settlement payments on interest rate swaps resulted in charges to interest expense of \$12.3 million compared to \$8.9 million for 2006 and net interest realized of \$71.7 million recognized as a reduction to interest expense in 2005, as the rates paid under the variable leg of the swaps exceeded the rates received during 2007 and 2006.

The provision for loan and lease losses for the year 2007 was \$120.6 million compared to \$75.0 million and \$50.6 million for the years 2006 and 2005, respectively. The increase in the Corporation's provision for 2007 was due to a deterioration in the credit quality of the Corporation's loan portfolio which is associated with the weakening economic conditions in Puerto Rico and the slowdown in the United States housing sector. These conditions resulted in higher net charge-offs relating to Puerto Rico consumer loans as well as commercial and construction loans, representing an increase of \$6.9 million and \$8.7 million, respectively, as compared to 2006 and higher provisions allocated to the Corporation's construction loan portfolio originated by the Miami Agency. During the second half of 2007, the Corporation recorded a specific reserve of \$8.1 million on four construction condominium-conversion loans (condo conversion loans) with an aggregate principal balance at the date of the evaluation of \$60.5 million extended to a single borrower through the Miami Agency based on an updated impairment analysis that incorporated new appraisals. Refer to the discussion under the Risk Management section below for an analysis of the allowance for loan and lease losses and non-performing assets and related ratios.

The above mentioned troubled relationship in the Miami Agency comprised four condo conversion loans that the Corporation had placed in non-accrual status during the second and third quarters of 2007. For the third quarter of 2007, the Corporation updated the impairment analysis on the relationship and requested new appraisals that reflected collateral deficiency as compared to the Corporation's recorded investment in the loans. The aggregate unpaid principal balance of the relationship classified as non-accrual decreased to \$46.4 million as of December 31, 2007, net of a charge-off of \$3.3 million recorded to this relationship in the fourth quarter of 2007. The charge-off was recorded at the time of sale of one of the loans in the relationship with an outstanding principal balance of \$14.1 million at the time of sale. This sale was made at a price of \$10.8 million, which exceeded the recorded investment in the loan (loan receivable less specific reserve) by approximately \$1 million. The Corporation continues to work on different alternatives to decrease the recorded investment in the non-accruing relationship on

the Miami Agency.

The Corporation maintains a constant monitoring of the Miami Agency portfolio. Recent loan reviews showed that the Miami Agency construction loan portfolio has an added susceptibility to current general market conditions and real estate trends in the U.S. market due to the oversupply of available property inventory and downward price pressures. Based on these factors and a detailed review of the portfolio, the Corporation determined it was prudent to increase general provisions allocated to this portfolio.

**Table of Contents**

The increase in the provision during 2006, as compared to 2005, principally reflects growth in the Corporation's commercial, excluding loans to local financial institutions, and consumer portfolios, and increasing trends in non-performing loans experienced during 2006 as compared to 2005. The Corporation's net charge-offs and non-performing loans were affected by the fiscal and economic situation of Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico has been in the midst of a recession since the third quarter of 2005. The slowdown in activity is the result of, among other things, higher utility prices, higher taxes, governmental budget imbalances, the upward trend in short-term interest rates and the flattening of the yield curve, and higher levels of oil prices.

Non-interest income for the year ended December 31, 2007 was \$67.2 million compared to \$31.3 million and \$63.1 million for the years ended December 31, 2006 and 2005, respectively. The increase in non-interest income in 2007, compared to 2006, was mainly attributable to the income recognition of approximately \$15.1 million for indemnity of expenses, mainly from insurance carriers, related to the settlement of the class action lawsuit brought against the Corporation, a decrease of \$9.3 million in other-than-temporary impairment charges related to the Corporation's equity securities portfolio, the fluctuation resulting from gains and losses recorded on partial repayments of certain secured commercial loans extended to local financial institutions (a gain of \$2.5 million recorded in 2007 compared to a loss of \$10.6 million recorded in 2006), a higher gain on the sale of its credit card portfolio (a gain of \$2.8 million recorded in 2007 compared to \$0.5 million recorded in 2006) pursuant to a strategic alliance reached with a U.S. financial institution and higher income from service charges on loans (an increase of \$0.9 million or 16% as compared to 2006) due to the increase in the loan portfolio volume driven by new originations.

The decrease in non-interest income in 2006, compared to 2005, was mainly attributable to the aforementioned \$10.6 million loss recorded in 2006 on the partial extinguishment of a secured commercial loan extended to Doral Financial Corporation (Doral), an increase in other-than-temporary impairment charges of \$6.9 million in the Corporation's investment portfolio and lower gains on the sale of investments of \$13.7 million. These negative variances were partially offset by increases of \$1.8 million in commission income from the Corporation's insurance business and \$1.3 million in service charges on deposit accounts and loans.

Non-interest expense for 2007 was \$307.8 million compared to \$288.0 million and \$315.1 million for the years 2006 and 2005, respectively. The increase in non-interest expenses for 2007, as compared to 2006, was mainly due to a \$12.8 million increase in employees' compensation and benefits expense primarily due to increases in the average compensation and related fringe benefits paid to employees, coupled with the accrual of approximately \$3.3 million for a voluntary separation program established by the Corporation as part of its cost saving strategies, a \$5.1 million increase in the deposit insurance premium expense resulting from changes in the premium calculation by the Federal Deposit Insurance Corporation (FDIC) effective in 2007, a \$4.5 million increase in occupancy and equipment expenses mainly attributable to increases in costs associated with the expansion of the Corporation's branch network and loan origination offices and an increase of \$6.4 million in other operating expenses primarily attributable to a \$3.3 million increase related to costs associated with capital raising efforts in 2007 not qualifying for capitalization coupled with increased costs associated with foreclosure actions on the aforementioned loan relationship at the Miami Agency. These factors were partially offset by an \$11.3 million decrease in professional fees attributable to the conclusion during 2006 of the Audit Committee's review and the restatement process.

The decrease in non-interest expense for 2006 compared to 2005 was mainly due to the accruals in 2005 of \$74.25 million and \$8.5 million recorded in connection with potential settlements of the



class action lawsuits and Securities and Exchange Commission ( SEC ) investigation, respectively, as a result of the Corporation's restatement. Excluding these accruals, non-interest expense during 2006 increased by \$55.6 million compared to 2005 mainly due to increases of \$25.4 million in employees compensation and benefits, \$6.9 million in occupancy and equipment and \$14.6 million in professional fees due to legal, accounting and consulting fees associated with the internal review conducted by the Corporation's Audit Committee as a result of the restatement announcement and other related legal and regulatory matters.

Income tax expense for the year ended December 31, 2007 was \$21.6 million (or 24% of pre-tax earnings) compared to \$27.4 million (or 24% of pre-tax earnings) and \$15.0 million (or 12% of pre-tax earnings) for the years ended December 31, 2006 and 2005, respectively. The decrease in income tax expense in 2007 as compared to 2006 was primarily due to a lower taxable income coupled with the effect of a lower statutory tax rate in Puerto Rico for 2007 (39% in 2007 compared to 43.5% in 2006).

**Table of Contents**

The increase in income tax expense in 2006 as compared to 2005 was primarily due to the recognition of deferred tax benefits of \$28.5 million in 2005 related to the potential class action lawsuit settlement that was partially offset by a decrease in the current income tax provision due to lower taxable income. The decrease in current income tax provision for 2006 compared to 2005 was mainly due to a decrease in taxable income partially offset by a change in the Corporation's proportion of exempt and taxable income coupled with an increase in non-qualifying income of the International Banking Entities that under current legislation were taxed at regular rates.

Total assets as of December 31, 2007 amounted to \$17.2 billion, a reduction of \$203.3 million compared to \$17.4 billion as of December 31, 2006. The decline was driven from the sale of investment securities and prepayments and maturities of investment securities not reinvested as part of the Corporation's strategy to deleverage its balance sheet and protect its net interest margin and the use of funds to pay down brokered certificates of deposit (CDs) and repurchase agreements as they matured. Furthermore, the Corporation's deferred tax asset as of December 31, 2007 decreased by \$72.0 million as compared to the balance as of December 31, 2006, mainly due to the effect of adoption of SFAS 159 on January 1, 2007 of approximately \$58.7 million and a reversal related with the class action settlement paid in 2007.

Total liabilities as of December 31, 2007 were \$15.8 billion, a reduction of \$395.4 million compared to \$16.2 billion as of December 31, 2006. The decrease is mainly attributable to decreases in federal funds purchased and securities sold under repurchase agreements consistent with the deleverage of the investment portfolio and to the redemption of the Corporation's \$150 million callable fixed-rate medium-term note during 2007. This was partially offset by an increase in the amount of advances from the FHLB.

The Corporation's stockholders' equity amounted to \$1.4 billion as of December 31, 2007, an increase of \$192.1 million compared to the balance as of December 31, 2006. The increase in stockholders' equity as of December 31, 2007 mainly consists of after-tax adjustments to beginning retained earnings of approximately \$91.8 million from the adoption of SFAS 159 and net proceeds of approximately \$91.9 million from the issuance to the Bank of Nova Scotia (Scotiabank) of 9.250 million shares of common stock in August 2007.

Total loan production, including purchases, for the year ended December 31, 2007 was \$4.1 billion compared to \$4.9 billion and \$6.5 billion for the years ended December 31, 2006 and 2005, respectively. The decrease in loan production was mainly due to decreases in the origination of residential real estate and commercial loans. The decrease in mortgage and commercial loan production for 2007 compared to 2006 and 2005 was attributable, among other things, to the slowdown in the Puerto Rico and U.S. housing market and to stricter underwriting standards.

Total non-performing loans as of December 31, 2007 was \$413.1 million compared to \$252.1 million as of December 31, 2006. The increase was mainly attributable to an increase of \$94.2 million in our non-performing residential real estate loans (mostly in Puerto Rico), as compared to the balance as of December 31, 2006, and the previously described classification as non-accrual of one loan relationship in the Miami Agency, amounting to approximately \$46.4 million as of December 31, 2007, net of a charge-off of \$3.3 million recorded to this relationship in the fourth quarter of 2007. Total non-performing loans of \$413.1 million as of December 31, 2007 reflected an increase of only 2% as compared to the balance as of the end of the previous trailing quarter ended on September 30, 2007. The Corporation has already started foreclosure proceedings on the real estate collaterals of the impaired loans relationship from the Miami Agency. The common form of foreclosure in Puerto Rico is judicial foreclosure and in average foreclosure proceedings takes longer than in the United States (non-judicial). In average, foreclosure proceedings in Puerto Rico takes 14 to 20 months in comparison to an average of

5 months in the United States based on HUD's foreclosure timeframes.

The Corporation may experience additional increases in the volume of its non-performing residential mortgage loan portfolio due to Puerto Rico's current economic recession. The Corporation started during the third quarter of 2007 a loan loss mitigation program providing homeownership preservation assistance. The Corporation has completed approximately 183 loan modifications, related to residential mortgage loans with an outstanding principal balance of \$26.0 million before the modification, that involves changes in one or more of the loan terms to bring a defaulted loan current and provide sustainable affordability.

**Table of Contents****CRITICAL ACCOUNTING POLICIES AND PRACTICES**

The accounting principles of the Corporation and the methods of applying these principles conform with generally accepted accounting principles in the United States and to general practices within the banking industry. The Corporation's critical accounting policies relate to the 1) allowance for loan and lease losses; 2) other-than-temporary impairments; 3) income taxes; 4) classification and related values of investment securities; 5) valuation of financial instruments; 6) derivative financial instruments; and 7) income recognition on loans. These critical accounting policies involve judgments, estimates and assumptions made by management that affect the recorded assets and liabilities and contingent assets and liabilities disclosed as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from estimates, if different assumptions or conditions prevail. Certain determinations inherently have greater reliance on the use of estimates, assumptions, and judgments and, as such, have a greater possibility of producing results that could be materially different than those originally reported.

**Allowance for Loan and Lease Losses**

The Corporation maintains the allowance for loan and lease losses at a level that management considers adequate to absorb losses inherent in the loans and leases portfolio. The adequacy of the allowance for loan and lease losses is reviewed on a quarterly basis as part of the Corporation's continued evaluation of its asset quality. The portfolios of residential mortgage loans, consumer loans, auto loans and finance leases are individually considered homogeneous and each portfolio is evaluated collectively for impairment. In estimating the allowance for loan and lease losses, management uses historical information about loan and lease losses as well as other factors including the effects on the loan portfolio of current economic indicators and their probable impact on the borrowers, information about trends on charge-offs and non-accrual loans, changes in underwriting policies, risk characteristics relevant to the particular loan category and delinquencies. The Corporation measures impairment individually for those commercial and real estate loans with a principal balance exceeding \$1 million in accordance with the provisions of SFAS 114, Accounting by Creditors for Impairment of a Loan. A loan is impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. An allowance for impaired loans is established based on the present value of expected future cash flows or the fair value of the collateral, if the loan is collateral dependent. If foreclosure is probable, the creditor is required to measure the impairment based on the fair value of the collateral. The fair value of the collateral is generally obtained from appraisals. Updated appraisals are obtained when the Corporation determines that loans are impaired and for certain loans on a spot basis selected by specific characteristics such as delinquency levels and loan-to-value ratios. Should the appraisal show a deficiency, the Corporation records a specific allowance for loan losses related to these loans.

As a general procedure, the Corporation internally reviews appraisals on a spot basis as part of the underwriting and approval process. For construction loans in the Miami Agency, appraisals are reviewed by an outsourced contracted appraiser. Once a loan backed by real estate collateral deteriorates or is accounted for in non-accrual status, a full assessment of the value of the collateral is performed. If the Corporation commences litigation to collect an outstanding loan or commences foreclosure proceedings against a borrower (which includes the collateral), a new appraisal report is requested and the book value is adjusted accordingly, either by a corresponding reserve or a charge-off.

The allowance for loan and lease losses requires significant judgments and estimates. The Corporation establishes the allowance for loan and lease losses based on whether it has classified the loans and leases as loss or probable loss currently inherent in the portfolio. The Corporation establishes an allowance to cover the total amount of any assets classified as a loss, the probable loss exposure of other classified assets, and the estimated losses of assets not classified. The adequacy of the allowance for loan and lease losses is based upon a number of factors including historical loan and leases loss experience that may not represent current conditions inherent in the portfolio. For example, factors affecting the Puerto Rico, Florida (USA), US Virgin Islands or British Virgin Islands economies may contribute to delinquencies and defaults above the Corporation's historical loan and lease losses. The Corporation addresses this risk by actively monitoring the delinquency and default experience and by considering current economic and market conditions. Based on the assessments of current conditions, the



**Table of Contents**

Corporation makes appropriate adjustments to the historically developed assumptions when necessary to adjust historical factors to account for present conditions.

**Other-than-temporary impairments**

The Corporation evaluates its investment securities for impairment on a quarterly basis or earlier if other factors indicative of potential impairment exist. An impairment charge in the consolidated statements of income is recognized when the decline in the fair value of investments below their cost basis is judged to be other-than-temporary. The Corporation considers various factors in determining whether it should recognize an impairment charge, including but not limited to, the length of time and extent to which the fair value has been less than its cost basis and the Corporation's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. For debt securities, the Corporation also considers, among other factors, the obligor's repayment ability on its bond obligations and its cash and capital generation ability. Any change in the factors evaluated to determine the need for an impairment charge could have an impact on that decision.

**Income Taxes**

The Corporation is required to estimate income taxes in preparing its consolidated financial statements. This involves the estimation of current income tax expense together with an assessment of temporary differences resulting from the differences in the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The determination of current income tax expense involves estimates and assumptions that require the Corporation to assume certain positions based on its interpretation of current tax regulations. Management assesses the relative benefits and risks of the appropriate tax treatment of transactions, taking into account statutory, judicial and regulatory guidance and recognizes tax benefits only when deemed probable. Changes in assumptions affecting estimates may be required in the future and estimated tax liabilities may need to be increased or decreased accordingly. The accrual of tax contingencies is adjusted in light of changing facts and circumstances, such as the progress of tax audits, case law and emerging legislation. The Corporation's effective tax rate includes the impact of tax contingencies and changes to such accruals, as considered appropriate by management. When particular matters arise, a number of years may elapse before such matters are audited by the taxing authorities and finally resolved. Favorable resolution of such matters or the expiration of the statute of limitations may result in the release of tax contingencies which are recognized as a reduction to the Corporation's effective rate in the year of resolution. Unfavorable settlement of any particular issue could increase the effective rate and may require the use of cash in the year of resolution. As of December 31, 2007, there were no open income tax investigations. Information regarding income taxes is included in Note 25 to the Corporation's audited financial statements.

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of the Corporation's net deferred tax assets assumes that the Corporation will be able to generate sufficient future taxable income based on estimates and assumptions. If these estimates and related assumptions change, the Corporation may be required to record valuation allowances against its deferred tax assets resulting in additional income tax expense in the consolidated statements of income. Management evaluates its deferred tax assets on a quarterly basis and assesses the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Corporation's tax provision in the period of change (see Note 25 to the consolidated audited financial statements).

SFAS 109, Accounting for Income Taxes, requires companies to make adjustments to their financial statements in the quarter that new tax legislation is enacted. In the third quarter of 2005, the Puerto Rico legislature passed and the governor signed into law a temporary two-year additional surtax of 2.5% applicable to corporations. The surtax was applicable to taxable years after December 31, 2004 and increases the maximum marginal corporate income tax rate from 39% to 41.5% until December 31, 2006. On May 13, 2006, with an effective date of January 1, 2006, the Government of Puerto Rico signed Law No. 89 which imposes an additional 2.0% income tax on all companies covered by the Puerto Rico Banking Act which resulted in an additional tax provision of \$1.7 million for 2006. For 2007 the maximum marginal corporate income tax rate was 39%.

**Table of Contents**

Act 98 of May 16, 2006, amended the Puerto Rico Internal Revenue Code by imposing a tax of 5% over the 2005 taxable net income applicable to corporations with gross income over \$10 million, which was required to be paid July 31, 2006. The Corporation can use the full payment as a tax credit in its income tax return for future years. The prepayment of tax resulted in a disbursement of \$7.1 million. No net income tax expense was recorded since the prepayment will be used as a tax credit in future taxable years.

The Corporation adopted Financial Accounting Standards Board Interpretation No. ( FIN ) 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 effective January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. This Interpretation prescribes 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. The cumulative effect of adoption of FIN 48 resulted in an increase of \$2.6 million to tax reserves with offsetting adjustments to retained earnings. Additionally, in connection with the adoption of FIN 48, the Corporation elected to classify interest and penalties related to unrecognized tax portions as components of income tax expense.

**Investment Securities Classification and Related Values**

Management determines the appropriate classification of debt and equity securities at the time of purchase. Debt securities are classified as held-to-maturity when the Corporation has the intent and ability to hold the securities to maturity. Held-to-maturity ( HTM ) securities are stated at amortized cost. Debt and equity securities are classified as trading when the Corporation has the intent to sell the securities in the near term. Debt and equity securities classified as trading securities are reported at fair value, with unrealized gains and losses included in earnings. Debt and equity securities not classified as HTM or trading, except for equity securities which do not have readily available fair values, are classified as available-for-sale ( AFS ). AFS securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported net of deferred taxes in accumulated other comprehensive income (a component of stockholders equity). Investments in equity securities that do not have publicly and readily determinable fair values are classified as other equity securities in the statement of financial condition and carried at the lower of cost or realizable value. The assessment of fair value applies to certain of the Corporation s assets and liabilities, including the investment portfolio. Fair values are volatile and are affected by factors such as market interest rates, prepayment speeds and discount rates.

**Table of Contents****Valuation of financial instruments**

The measurement of fair value is fundamental to the Corporation's presentation of financial condition and results of operations. The Corporation holds fixed income and equity securities, derivatives, investments and other financial instruments at fair value. The Corporation holds its investments and liabilities on the statement of financial condition mainly to manage liquidity needs and interest rate risks. A substantial part of these assets and liabilities is reflected at fair value on the Corporation's financial statement of condition.

Effective January 1, 2007, the Corporation elected to early adopt SFAS 157, 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 when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1** Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2** Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3** Valuations are observed from unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

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

*Callable Brokered CDs (Level 2 inputs)*

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 interest rate 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 as required by SFAS 157.

*Medium-Term Notes (Level 2 inputs)*

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 interest rate 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 as required by SFAS 157. 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.



**Table of Contents***Investment Securities*

The fair value of investment securities is the market value based on quoted market prices, when available, (Level 1) or market prices obtained from third-party pricing services for identical or comparable assets (Level 2). If listed prices or quotes are not available, fair value is based upon externally developed models that are unobservable inputs due to the limited market activity of the instrument (Level 3), as is the case with certain private label mortgage-backed securities held by the Corporation. Unlike U.S. agency mortgage-backed securities, the fair value of these private label securities cannot be readily determined because they are not actively traded in securities markets. Significant information used for fair value determination is proprietary with regards to specific characteristics such as the prepayment model which follows the amortizing schedule of the underlying loans, which is an unobservable input.

Private label mortgage-backed securities are collateralized by mortgages on single-family residential properties in the United States. The Corporation derived the fair value for these private label securities based on a market valuation received from a third party. The market valuation is calculated by discounting the estimated net cash flows over the projected life of the pool of underlying assets using prepayment, default and interest rate assumptions that market participants would commonly use for similar mortgage asset classes that are subject to prepayment, credit and interest rate risk.

*Derivative Instruments*

The fair value of the derivative instruments is provided by valuation experts and counterparties (Level 2). Certain derivatives with limited market activity, as is the case with derivative instruments named as reference caps, are valued using externally developed models that consider unobservable market parameters (Level 3). Reference caps are used to mainly hedge interest rate risk inherent on private label mortgage-backed securities, thus are tied to the notional amount of the underlying mortgage loans originated in the United States. Significant information used for fair value determination is proprietary with regards to specific characteristics such as the prepayment model which follows the amortizing schedule of the underlying loans, which is an unobservable input.

The Corporation derived the fair value of reference caps based on a market valuation received from a third party. The valuation model uses Black formula which is a benchmark standard in financial industry. The Black formula uses as inputs the strike price of the cap, forward LIBOR rates, volatility estimates and discount rates to estimate the option value. LIBOR rates and swap rates used in the model are obtained from Bloomberg L.P. (Bloomberg) every day and build zero coupon curve based on the Bloomberg LIBOR/Swap curve. The discount factor is then calculated from the zero coupon curve. The cap is the sum of all caplets. For each caplet, the rate is reset at the beginning of each reporting period and payments are made at the end of each period. The cash flow of caplet is then discounted from each payment date.

**Derivative Financial Instruments**

As part of the Corporation's overall interest rate risk management, the Corporation utilizes derivative instruments, including interest rate swaps, interest rate caps and options to manage interest rate risk. In accordance with SFAS 133, Accounting for Derivative Instruments and Hedging Activities, all derivative instruments are measured and recognized on the Consolidated Statements of Financial Condition at their fair value. On the date the derivative instrument contract is entered into, the Corporation may designate the derivative as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge) or (3) as a standalone derivative instrument, including economic hedges that the Corporation has not formally documented as a fair value or cash flow hedge. Changes in the fair value of a derivative instrument that is highly effective and that is designated and qualifies as a fair-value hedge, along with changes in the fair value of the hedged asset or liability that is attributable to the hedged risk (including gains or losses on firm commitments), are recorded in current-period earnings as interest income or interest expense depending upon whether an asset or liability is being hedged. Similarly, the changes in the fair value of standalone derivative instruments or derivatives not qualifying or designated for hedge accounting under SFAS 133 are reported in current-period earnings as interest income or interest expense depending upon whether an asset or liability is being economically hedged. Changes in the fair value of a derivative instrument that is highly effective and that is designated and qualifies as a cash-flow hedge, if any, are recorded in other comprehensive income in the stockholders' equity section of the Consolidated Statements of Financial Condition until earnings are affected by the variability of cash flows (e.g., when periodic settlements on a variable-rate asset or liability are recorded in earnings). None of the Corporation's derivative instruments qualified or has been designated as a cash flow hedge.

Prior to entering into an accounting hedge transaction or designating a hedge, the Corporation formally documents the relationship between the hedging instrument and the hedged item, as well as the risk management objective and strategy for undertaking the hedge transaction. This process includes linking all derivative instruments that are designated as fair value or cash flow hedges to specific assets and liabilities on the statements of financial condition or to specific firm commitments or forecasted transactions along with a formal assessment at both inception of the hedge and on an ongoing basis as to the effectiveness of the derivative instrument in offsetting changes in fair values or cash flows of the hedged item. The Corporation discontinues hedge accounting prospectively when it determines that the derivative is not effective or will no longer be effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative expires, is sold, or terminated, or management determines that designation of the derivative as a hedging instrument is no longer appropriate. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability as a yield adjustment.

The Corporation recognizes unrealized gains and losses arising from any changes in fair value of derivative instruments and hedged items, as applicable, as interest income or interest expense depending upon whether an asset or liability is being hedged.

**Table of Contents**

The Corporation occasionally purchases or originates financial instruments that contain embedded derivatives. At inception of the financial instrument, the Corporation assesses: (1) if the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the financial instrument (host contract), (2) if the financial instrument that embodies both the embedded derivative and the host contract is measured at fair value with changes in fair value reported in earnings, or (3) if a separate instrument with the same terms as the embedded instrument would not meet the definition of a derivative. If the embedded derivative does not meet any of these conditions, it is separated from the host contract and carried at fair value with changes recorded in current period earnings as part of net interest income. Information regarding derivative instruments is included in Note 30 to the Corporation's audited financial statements.

Effective January 1, 2007, the Corporation elected to early adopt SFAS 159. This Statement allows entities to choose to measure certain financial assets and liabilities at fair value with any 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 Measurement. The Corporation decided to early adopt SFAS 159 for approximately \$4.4 billion, of the callable brokered CDs and approximately \$15.4 million of the callable fixed medium-term notes ( SFAS 159 liabilities ), 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, for the portfolio of callable interest rate swaps, callable brokered CDs and callable notes. One of the main considerations in the determination 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.

With the Corporation's elimination of the use of the long-haul method in connection with the adoption of SFAS 159, the Corporation no longer amortizes or accretes the basis adjustment for the SFAS 159 liabilities. The basis adjustment amortization or accretion is the reversal of the basis differential between the market value and book value recognized at the inception of fair value hedge accounting as well as 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 establishes 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 resulted 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 159. Refer to Note 27 to the audited consolidated financial statements for required disclosures and further information on the impact of adoption of this accounting pronouncement.

Prior to the implementation of the long-haul method First BanCorp reflected changes in the fair value of those swaps as well as swaps related to certain loans as non-hedging instruments through operations as part of net interest income.

**Income Recognition on Loans**

Loans are stated at the principal outstanding balance, net of unearned interest, unamortized deferred origination fees and costs and unamortized premiums and discounts. Fees collected and costs incurred in the origination of new loans are deferred and amortized using the interest method or a method which approximates the interest method over the term of the loan as an adjustment to interest yield. Unearned interest on certain personal, auto loans and finance leases is recognized as income under a method which approximates the interest method. When a loan is paid off or sold, any unamortized net deferred fee (cost) is credited (charged) to income.

Loans on which the recognition of interest income has been discontinued are designated as non-accruing. When loans are placed on non-accruing status, any accrued but uncollected interest income is reversed and charged against

**Table of Contents**

interest income. Consumer, commercial and mortgage loans are classified as non-accruing when interest and principal have not been received for a period of 90 days or more. This policy is also applied to all impaired loans based upon an evaluation of the risk characteristics of said loans, loss experience, economic conditions and other pertinent factors. Loan and lease losses are charged and recoveries are credited to the allowance for loan and lease losses. Closed-end consumer loans and leases are charged-off when payments are 120 days in arrears. Open-end (revolving credit) consumer loans are charged-off when payments are 180 days in arrears.

The Corporation may also classify loans in non-accruing status and recognize revenue only when cash payments are received because of the deterioration in the financial condition of the borrower and payment in full of principal or interest is not expected. In addition, the Corporation started during the third quarter of 2007 a loan loss mitigation program providing homeownership preservation assistance. Loans modified through this program are reported as non-performing loans and interest is recognized on a cash basis. When there is reasonable assurance of repayment and the borrower has made payments over a sustained period, the loan is returned to accruing status.

**Recent Accounting Pronouncements**

The Financial Accounting Standards Board ( FASB ) and the SEC have issued the following accounting pronouncements and discussions relevant to the Corporation's operations:

On April 30, 2007, the FASB issued FASB Staff Position No. FIN 39-1 ( FSP FIN 39-1 ), which amends FIN 39, Offsetting of Amounts Related to Certain Contracts. 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 analyzed the impact of FSP FIN 39-1 on its financial statements considering its portfolio of derivative instruments. As of December 31, 2007, the Corporation has not been able to apply this pronouncement since FSP FIN 39-1 applies only to cash collateral and all of the collateral received or delivered to counterparties for derivative instruments are investment securities.

In November 2007, the SEC issued Staff Accounting Bulletin No. ( SAB ) 109 Written Loan Commitments That Are Accounted For At Fair Value Through Earnings Under Generally Accepted Accounting Principles . This interpretation expresses the views of the staff regarding written loan commitments that are accounted for at fair value through earnings under generally accepted accounting principles. SAB 109 supersedes SAB 105, Application of Accounting Principles to Loan Commitments, which provided the prior views of the staff regarding derivative loan commitments that are accounted for at fair value through earnings pursuant to SFAS 133. SAB 109 expresses the current view of the staff that, consistent with the guidance in SFAS 156, Accounting for Servicing of Financial Assets , and SFAS 159, the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB 109 is effective for fiscal quarters beginning after December 15, 2007. The Corporation is currently evaluating the effect, if any, of the adoption of this interpretation on its Financial Statements, commencing on January 1, 2008.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51. This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. The Corporation is currently evaluating the effect, if any, of the adoption of this statement on its Financial Statements, commencing on January 1, 2009.

**Table of Contents**

In December 2007, the FASB issued SFAS 141R, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. This Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, including contingent liabilities and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The Corporation is currently evaluating the effect, if any, of the adoption of this statement on its Financial Statements.

**RESULTS OF OPERATIONS**

First BanCorp's results of operations depend primarily upon its net interest income, which is the difference between the interest income earned on its interest-earning assets, including investment securities and loans, and the interest expense on its interest-bearing liabilities, including deposits and borrowings. Net interest income is affected by various factors including the interest rate scenario, the volumes, mix and composition of interest-earning assets and interest-bearing liabilities; and the re-pricing and/or maturity mismatch of these assets and liabilities. Refer to Risk Management Interest Rate Risk Management below for additional information on the Corporation's exposure to interest rate risk. The Corporation's results of operations also depend on the provision for loan and lease losses, non-interest expenses (such as personnel, occupancy and other costs), non-interest income (mainly service charges and fees on loans and deposit accounts), the results of its hedging activities, gains (losses) on investments and gains (losses) on sale of loans, and income taxes.

**Net Interest Income**

Net interest income is the excess of interest earned by First BanCorp on its interest-earning assets over the interest incurred on its interest-bearing liabilities. First BanCorp's net interest income is subject to interest rate risk due to the re-pricing and maturity mismatch of the Corporation's assets and liabilities. Net interest income for the year ended December 31, 2007 was \$451.0 million, compared to \$443.7 million and \$432.3 million for 2006 and 2005, respectively. On a tax equivalent basis and excluding the changes in the fair value of derivative instruments, the ineffective portion resulting from fair value hedge accounting in 2006, the basis adjustment amortization or accretion and unrealized gains and losses on SFAS 159 liabilities, net interest income for the year ended December 31, 2007 was \$475.4 million, compared to \$529.9 million and \$566.9 million for 2006 and 2005, respectively.

The following tables include a detailed analysis of net interest income. Part I presents average volumes and rates on an adjusted tax equivalent basis and Part II presents, also on an adjusted tax equivalent basis, the extent to which changes in interest rates and changes in volume of interest-related assets and liabilities have affected the Corporation's net interest income. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to changes in volume (changes in volume multiplied by old rates), and changes in rate (changes in rate multiplied by old volumes). Rate-volume variances (changes in rate multiplied by changes in volume) have been allocated to the changes in volume and rate based upon their respective percentage of the combined totals.

**Table of Contents**

For periods after the adoption of fair value hedge accounting and SFAS 159, the net interest income is computed on an adjusted tax equivalent basis by excluding: (1) the change in the fair value of derivative instruments, (2) the ineffective portion of designated hedges, (3) the basis adjustment amortization or accretion and (4) unrealized gains or losses on SFAS 159 liabilities. For periods prior to the adoption of hedge accounting, the net interest income is computed on an adjusted tax equivalent basis by excluding the impact of the change in the fair value of derivatives (refer to explanation below regarding changes in the fair value of derivative instruments).

**Table of Contents****Part I**

| Period ended December 31,              | 2007          | Average       | Interest Income (1) / expense |              |              | Average rate (1) |        |        |       |
|--|---------------|---------------|-------------------------------|--------------|--------------|------------------|--------|--------|-------|
|  |               | volume        | 2005                          | 2007         | 2006         | 2005             | 2007   | 2006   | 2005  |
| (Dollars in thousands)                 |               |               |                               |              |              |                  |        |        |       |
| Earning assets:                        |               |               |                               |              |              |                  |        |        |       |
| Money market investments               | \$ 440,598    | \$ 1,444,533  | \$ 636,114                    | \$ 22,155    | \$ 72,755    | \$ 22,191        | 5.03%  | 5.04%  | 3.4%  |
| Government obligations (2)             | 2,687,013     | 2,827,196     | 2,493,725                     | 159,572      | 170,088      | 166,724          | 5.94%  | 6.02%  | 6.6%  |
| Mortgage-backed securities             | 2,296,855     | 2,540,394     | 2,738,388                     | 117,383      | 128,096      | 152,813          | 5.11%  | 5.04%  | 5.5%  |
| Corporate bonds                        | 7,711         | 8,347         | 48,311                        | 510          | 574          | 2,487            | 6.61%  | 6.88%  | 5.1%  |
| REMIC stock                            | 46,291        | 26,914        | 71,588                        | 2,861        | 2,009        | 3,286            | 6.18%  | 7.46%  | 4.5%  |
| Equity securities                      | 8,133         | 27,155        | 50,784                        | 3            | 350          | 1,686            | 0.04%  | 1.29%  | 3.3%  |
| Real estate investments (3)            | 5,486,601     | 6,874,539     | 6,038,910                     | 302,484      | 373,872      | 349,187          | 5.51%  | 5.44%  | 5.7%  |
| Commercial real estate loans           | 2,914,626     | 2,606,664     | 1,813,506                     | 188,294      | 171,333      | 121,066          | 6.46%  | 6.57%  | 6.6%  |
| Construction loans                     | 1,467,621     | 1,462,239     | 710,753                       | 121,917      | 126,592      | 52,300           | 8.31%  | 8.66%  | 7.3%  |
| Commercial loans                       | 4,797,440     | 5,593,018     | 7,171,366                     | 362,714      | 401,027      | 395,280          | 7.56%  | 7.17%  | 5.5%  |
| Finance leases                         | 379,510       | 322,431       | 243,384                       | 33,153       | 28,934       | 22,263           | 8.74%  | 8.97%  | 9.1%  |
| Consumer loans                         | 1,729,548     | 1,783,384     | 1,570,468                     | 202,616      | 214,967      | 191,071          | 11.71% | 12.05% | 12.1% |
| Total loans (4)(5)                     | 11,288,745    | 11,767,736    | 11,509,477                    | 908,694      | 942,853      | 781,980          | 8.05%  | 8.01%  | 6.7%  |
| Total earning assets                   | \$ 16,775,346 | \$ 18,642,275 | \$ 17,548,387                 | \$ 1,211,178 | \$ 1,316,725 | \$ 1,131,167     | 7.22%  | 7.06%  | 6.4%  |
| Interest-bearing liabilities:          |               |               |                               |              |              |                  |        |        |       |
| Interest-bearing checking              |               |               |                               |              |              |                  |        |        |       |
| Accounts                               | \$ 443,420    | \$ 371,422    | \$ 376,360                    | \$ 11,365    | \$ 5,919     | \$ 4,730         | 2.56%  | 1.59%  | 1.2%  |
| Savings accounts                       | 1,020,399     | 1,022,686     | 1,092,938                     | 15,037       | 12,970       | 12,572           | 1.47%  | 1.27%  | 1.1%  |
| Certificates of deposit                | 9,291,900     | 10,479,500    | 8,386,463                     | 498,048      | 531,188      | 306,687          | 5.36%  | 5.07%  | 3.6%  |
| Total interest-bearing deposits        | 10,755,719    | 11,873,608    | 9,855,761                     | 524,450      | 550,077      | 323,989          | 4.88%  | 4.63%  | 3.2%  |
| Other borrowed funds                   | 3,449,492     | 4,543,262     | 5,001,384                     | 172,890      | 223,069      | 207,503          | 5.01%  | 4.91%  | 4.1%  |
| REMIC advances                         | 723,596       | 273,395       | 890,680                       | 38,464       | 13,704       | 32,756           | 5.32%  | 5.01%  | 3.6%  |
| Total interest-bearing liabilities (6) | \$ 14,928,807 | \$ 16,690,265 | \$ 15,747,825                 | \$ 735,804   | \$ 786,850   | \$ 564,248       | 4.93%  | 4.71%  | 3.5%  |
| Total interest income                  |               |               |                               | \$ 475,374   | \$ 529,875   | \$ 566,919       |        |        |       |
| Interest rate spread                   |               |               |                               |              |              |                  | 2.29%  | 2.35%  | 2.8%  |
| Interest margin                        |               |               |                               |              |              |                  | 2.83%  | 2.84%  | 3.2%  |

(1) On an adjusted tax equivalent basis. The adjusted tax



equivalent yield was estimated by dividing the interest rate spread on exempt assets by (1 less Puerto Rico statutory tax rate (39% for 2007 and 43.5% for the Corporation's Puerto Rico banking subsidiary in 2006, 41.5% for all other subsidiaries in 2006 and 41.5% for all subsidiaries in 2005)) and adding to it the cost of interest-bearing liabilities. When adjusted to a tax equivalent basis, yields on taxable and exempt assets are comparable. Changes in the fair value of derivative instruments (including the ineffective portion after the adoption of hedge accounting in the second quarter of 2006), unrealized gains or losses on SFAS 159 liabilities, and basis adjustment amortization or accretion are excluded from interest income and interest expense for average rate

calculation purposes because the changes in valuation do not affect interest paid or received.

- (2) Government obligations include debt issued by government sponsored agencies.
- (3) Unrealized gains and losses in available-for-sale securities are excluded from the average volumes.
- (4) Average loan balances include the average of non-accruing loans, on which interest income is recognized when collected.
- (5) Interest income on loans includes \$11.1 million, \$14.9 million, and \$11.0 million for 2007, 2006 and 2005, respectively, of income from prepayment penalties and late fees related to the Corporation's loan portfolio.
- (6) Unrealized gains and losses on SFAS 159 liabilities are excluded from the

average volumes.

**Table of Contents****Part II**

|   | 2007 compared to 2006  |             |             | 2006 compared to 2005 |              |             |
|---|------------------------|-------------|-------------|-----------------------|--------------|-------------|
|   | Increase (decrease)    |             |             | Increase (decrease)   |              |             |
|   | Volume                 | Due to:     |             | Volume                | Due to:      |             |
| Rate  |                        | Total       | Rate        |                       | Total        |             |
|   | (Dollars in thousands) |             |             |                       |              |             |
| Interest income on interest-earning assets:       |                        |             |             |                       |              |             |
| Money market investments                          | \$ (50,485)            | \$ (115)    | \$ (50,600) | \$ 37,480             | \$ 13,084    | \$ 50,564   |
| Government obligations                            | (8,259)                | (2,257)     | (10,516)    | 21,179                | (17,815)     | 3,364       |
| Mortgage-backed securities                        | (12,367)               | 1,654       | (10,713)    | (10,593)              | (14,124)     | (24,717)    |
| Corporate bonds                                   | (41)                   | (23)        | (64)        | (2,403)               | 490          | (1,913)     |
| FHLB stock  | 1,323                  | (471)       | 852         | (2,693)               | 1,416        | (1,277)     |
| Equity securities                                 | (145)                  | (202)       | (347)       | (578)                 | (758)        | (1,336)     |
| Total investments                                 | (69,974)               | (1,414)     | (71,388)    | 42,392                | (17,707)     | 24,685      |
| Residential real estate loans                     | 20,070                 | (3,109)     | 16,961      | 52,540                | (2,273)      | 50,267      |
| Construction loans                                | 457                    | (5,132)     | (4,675)     | 63,662                | 10,630       | 74,292      |
| Commercial loans (1)                              | (58,602)               | 20,289      | (38,313)    | (100,083)             | 105,830      | 5,747       |
| Finance leases                                    | 5,054                  | (835)       | 4,219       | 7,162                 | (491)        | 6,671       |
| Consumer loans                                    | (6,396)                | (5,955)     | (12,351)    | 25,785                | (1,889)      | 23,896      |
| Total loans                                       | (39,417)               | 5,258       | (34,159)    | 49,066                | 111,807      | 160,873     |
| Total interest income                             | (109,391)              | 3,844       | (105,547)   | 91,458                | 94,100       | 185,558     |
| Interest expense on interest-bearing liabilities: |                        |             |             |                       |              |             |
| Deposits  | (53,151)               | 27,524      | (25,627)    | 75,385                | 150,703      | 226,088     |
| Other borrowed funds                              | (54,261)               | 4,082       | (50,179)    | (20,751)              | 36,317       | 15,566      |
| FHLB advances                                     | 23,883                 | 877         | 24,760      | (26,822)              | 7,770        | (19,052)    |
| Total interest expense                            | (83,529)               | 32,483      | (51,046)    | 27,812                | 194,790      | 222,602     |
| Change in net interest income                     | \$ (25,862)            | \$ (28,639) | \$ (54,501) | \$ 63,646             | \$ (100,690) | \$ (37,044) |

(1) Significant decrease in volume substantially relates to the payment

received of \$2.4 billion from a local financial institution to partially extinguish a secured commercial loan during the second quarter of 2006.

A portion of the Corporation's interest-earning assets, mostly investments in obligations of some U.S. Government agencies and sponsored entities, generate interest which is exempt from income tax, principally in Puerto Rico. Also interest and gains on sale of investments held by the Corporation's international banking entities are tax-exempt under the Puerto Rico tax law. To facilitate the comparison of all interest data related to these assets, the interest income has been converted to a taxable equivalent basis. The tax equivalent yield was estimated by dividing the interest rate spread on exempt assets by (1 less the Puerto Rico statutory tax rate (39% for 2007, 43.5% for the Corporation's Puerto Rico banking subsidiary in 2006, 41.5% for all other subsidiaries in 2006 and 41.5% for all subsidiaries in 2005)) and adding to it the average cost of interest-bearing liabilities. The computation considers the interest expense disallowance required by Puerto Rico tax law.

The presentation of net interest income excluding the effects of the changes in the fair value of the derivative instruments, including the ineffective portion for designated hedges after the adoption of fair value accounting, the basis adjustment amortization or accretion, and unrealized gains or losses on SFAS 159 liabilities provides additional information about the Corporation's net interest income and facilitates comparability and analysis. The changes in the fair value of the derivative instruments, the basis adjustment amortization or accretion, and unrealized gains or losses on SFAS 159 liabilities have no effect on interest due or interest earned on interest-bearing assets or interest-bearing liabilities, respectively, or on interest payments exchanged with swap counterparties.

The following table reconciles the interest income on an adjusted tax equivalent basis set forth in Part I above to interest income set forth in the Consolidated Statements of Income:

|  | <b>Year ended December 31,</b> |              |              |
|--|--------------------------------|--------------|--------------|
|  | <b>2007</b>                    | <b>2006</b>  | <b>2005</b>  |
|  | (Dollars in thousands)         |              |              |
| Interest income on an adjusted tax equivalent basis                            | \$ 1,211,178                   | \$ 1,316,725 | \$ 1,131,167 |
| Less: tax equivalent adjustments   | (15,293)                       | (27,987)     | (61,166)     |
| Plus: net unrealized (loss) gain on derivatives (economic undesignated hedges) | (6,638)                        | 75           | (2,411)      |
| Total interest income  | \$ 1,189,247                   | \$ 1,288,813 | \$ 1,067,590 |

**Table of Contents**

The following table summarizes the components of the changes in fair values of interest rate swaps and interest rate caps, which are included in interest income:

|  | <b>Year ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
|  | (Dollars in thousands)         |             |             |
| Unrealized (loss) gain on derivatives (economic undesignated hedges):    |                                |             |             |
| Interest rate caps   | \$ (3,985)                     | \$ (472)    | \$ (4,039)  |
| Interest rate swaps on corporate bonds                                   |                                | 27          | 823         |
| Interest rate swaps on loans   | (2,653)                        | 520         | 805         |
| Net unrealized (loss) gain on derivatives (economic undesignated hedges) | \$ (6,638)                     | \$ 75       | \$ (2,411)  |

The following table summarizes the components of interest expense for the years ended December 31, 2007, 2006 and 2005. As mentioned before, the net interest margin analysis excludes the changes in the fair value of derivatives, unrealized gains or losses on SFAS 159 liabilities, the ineffective portion of derivative instruments designated as fair value hedges under SFAS 133, and the basis adjustment:

|   | <b>Year ended December 31,</b> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
|   | (Dollars in thousands)         |             |             |
| Interest expense on interest-bearing liabilities  | \$ 713,918                     | \$ 757,969  | \$ 620,774  |
| Net interest incurred (realized) on interest rate swaps   | 12,323                         | 8,926       | (71,650)    |
| Amortization of placement fees on brokered certificates of deposit  | 9,056                          | 19,896      | 15,096      |
| Amortization of placement fees on medium-term notes   | 507                            | 59          | 28          |
| Interest expense excluding net unrealized and realized (gain) loss on derivatives (designated and economic undesignated hedges), net unrealized loss on SFAS 159 liabilities and accretion of basis adjustments | 735,804                        | 786,850     | 564,248     |
| Net unrealized and realized loss on derivatives (designated and economic undesignated hedges) and SFAS 159 liabilities  | 4,488                          | 61,895      | 71,023      |
| Accretion of basis adjustment   | (2,061)                        | (3,626)     |             |
| Total interest expense  | \$ 738,231                     | \$ 845,119  | \$ 635,271  |

The following table summarizes the components of the net unrealized and realized gain and loss on derivatives (designated and economic undesignated hedges) and net unrealized loss on SFAS 159 liabilities which are included in interest expense:

|  | <b>Year ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
|  | (Dollars in thousands)         |             |             |
| Unrealized (gain) loss on derivatives (designated hedges - ineffective portion): |                                |             |             |
| Interest rate swaps on brokered certificates of deposit                          | \$                             | \$ (3,989)  | \$          |
| Interest rate swaps on medium-term notes   |                                | (720)       |             |
|  |                                | (4,709)     |             |

Net unrealized (gain) loss on derivatives (designated hedges ineffective portion)

Unrealized and realized (gain) loss on derivatives (economic undesignated hedges):

|   |          |        |        |
|---|----------|--------|--------|
| Interest rate swaps and other derivatives on brokered certificates of deposit | (66,826) | 62,521 | 69,163 |
| Interest rate swaps and other derivatives on medium-term notes                | 692      | 4,083  | 1,860  |

|  |          |        |        |
|--|----------|--------|--------|
| Net unrealized (gain) loss on derivatives (economic undesignated hedges) | (66,134) | 66,604 | 71,023 |
|--|----------|--------|--------|

Unrealized loss (gain) on SFAS 159 liabilities:

|   |        |
|---|--------|
| Unrealized loss on brokered certificates of deposit | 71,116 |
| Unrealized gain on medium-term notes                | (494)  |

|   |        |
|---|--------|
| Net unrealized loss on SFAS 159 liabilities | 70,622 |
|---|--------|

|   |          |           |           |
|---|----------|-----------|-----------|
| Net unrealized loss on derivatives (designated and economic undesignated hedges) and SFAS 159 liabilities | \$ 4,488 | \$ 61,895 | \$ 71,023 |
|---|----------|-----------|-----------|

**Table of Contents**

The following table summarizes the components of the accretion of basis adjustment which are included in interest expense:

|   | <b>Year ended December 31,</b> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
|   | (Dollars in thousands)         |             |             |
| Accretion of basis adjustments on fair value hedges:    |                                |             |             |
| Interest rate swaps on brokered certificates of deposit | \$                             | \$ (3,576)  | \$          |
| Interest rate swaps on medium-term notes                | (2,061)                        | (50)        |             |
| Accretion of basis adjustments on fair value hedges     | \$ (2,061)                     | \$ (3,626)  | \$          |

Interest income on interest-earning assets primarily represents interest earned on loans receivable and investment securities.

Interest expense on interest-bearing liabilities primarily represents interest paid on brokered CDs, branch-based deposits, repurchase agreements and notes payable.

Net interest incurred or realized on interest rate swaps primarily represents net interest exchanged on pay-float swaps that hedge (economically or under fair value hedge accounting) brokered CDs and medium-term notes.

The amortization of broker placement fees represents the amortization of fees paid to brokers upon issuance of related financial instruments (i.e., brokered CDs). For 2007, the amortization of broker placement fees includes the derecognition of the unamortized balance of placement fees related to the \$150 million note redeemed prior to its contractual maturity during the second quarter as well as the amortization of placement fees for brokered CDs not elected for fair value option under SFAS 159.

Unrealized gains or losses on derivatives represent: (1) for economic or undesignated hedges, including derivative instruments economically hedging SFAS 159 liabilities changes in the fair value of derivatives, primarily interest rate swaps, that economically hedge liabilities (i.e., brokered CDs and medium-term notes) or assets (i.e., loans and corporate bonds), and (2) for designated hedges the ineffectiveness represented by the difference between the changes in the fair value of the derivative instrument (i.e., interest rate swaps) and changes in fair value of the hedged item (i.e., brokered CDs and medium-term notes).

For 2007, the Corporation recognized a realized loss of approximately \$10.7 million related to the termination of interest rate swaps that were no longer economically hedging brokered CDs as their notional amounts exceeded the balances of the brokered CDs. Also during 2007, the Corporation recorded a realized loss of \$5.4 million related to the termination of an interest rate swap that economically hedged the \$150 million medium-term note that was redeemed prior to its stated contractual maturity. The realized losses were substantially offset by the reversal of the cumulative mark-to-market valuation of the swaps as of the date of the transactions, resulting in a net reduction of earnings of approximately \$0.9 million for 2007.

Unrealized gains or losses on SFAS 159 liabilities represent the change in the fair value of liabilities (medium-term notes and brokered CDs), other than the accrual of interests, for which the Corporation elected the fair value option under SFAS 159.

For 2007, 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, was amortized or accreted based on the expected maturity of the liability as a yield adjustment. The unamortized balance of the basis adjustment was derecognized as part of the redemption of the \$150 million note resulting in an adjustment to earnings of \$1.9 million recognized as an accretion of basis adjustment, during the second quarter of 2007. For 2006, the basis adjustment represents the amortization or accretion of the basis differential between the market value and the book value of the hedged liabilities recognized at the inception of fair value hedge accounting, which was amortized or accreted to interest expense based on the expected maturity of the hedged liabilities as changes in value after the inception of the long-haul method.





**Table of Contents**

As shown on the tables above, the results of operations for 2007, 2006, and 2005 were significantly impacted by changes in the valuation of derivative instruments that hedge economically or under fair value designation the Corporation's brokered CDs and medium-term notes and by unrealized gains and losses on SFAS 159 liabilities. The adoption of fair value hedge accounting during the second quarter of 2006 and SFAS 159, effective January 1, 2007, reduced the earnings volatility caused by the fluctuation in the valuation of derivative instruments.

Derivative instruments, such as interest rate swaps, are subject to market risk. While the Corporation does have certain trading derivatives to facilitate customer transactions, the Corporation does not utilize derivative instruments for speculative purposes. The Corporation's derivatives are mainly composed of interest rate swaps that are used to convert the fixed interest payment on its brokered certificates of deposit and medium-term notes to variable payments (receive fixed/pay floating). Refer to the Risk Management Derivative discussion below for further details concerning the notional amounts of derivative instruments and additional information. As is the case with investment securities, the market value of derivative instruments is largely a function of the financial market's expectations regarding the future direction of interest rates. Accordingly, current market values are not necessarily indicative of the future impact of derivative instruments on net interest income. This will depend, for the most part, on the shape of the yield curve as well as the level of interest rates.

**2007 compared to 2006**

Net interest income increased to \$451.0 million for 2007 from \$443.7 million in 2006. The increase in net interest income for the year 2007, as compared to 2006, was mainly driven by the effect in 2006 earnings of unrealized non-cash losses related to changes in the fair value of derivative instruments prior to the implementation of fair value hedge accounting using the long-haul method on April 3, 2006. During the first quarter of 2006, the Corporation recorded changes in the fair value of derivative instruments as non-hedging instruments through operations recording unrealized losses of \$69.7 million for non-hedge derivatives as part of interest expense. The adoption of fair value hedge accounting in the second quarter of 2006 and the adoption of SFAS 159 in 2007 reduced the accounting volatility that previously resulted from the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. The change in the valuation of derivative instruments, the net unrealized loss on SFAS 159 liabilities, the basis adjustment and the ineffective portion on designated hedges recorded as part of net interest income (the valuation changes) resulted in a net non-cash loss of \$9.1 million for 2007, compared to a net unrealized loss of \$58.2 million for 2006.

For the year ended December 31, 2007, net interest income on an adjusted tax equivalent basis decreased 10% as compared to the previous year from \$529.9 million to \$475.4 million. Net interest income on an adjusted tax equivalent basis excludes the valuation changes. The decrease in net interest income on an adjusted tax equivalent basis was mainly driven by the continued pressure of the flattening of the yield curve during most of 2007 and the decrease in the average volume of interest-earning assets primarily due to the repayment of approximately \$2.4 billion received from a local financial institution reducing the balance of its secured commercial loan with the Corporation during the latter part of the second quarter of 2006. This partially extinguished secured commercial loan yielded 150 basis points over 3-month LIBOR. The repayment caused a reduction in net interest income of approximately \$15.0 million when comparing results for the year ended December 31, 2007 to previous year results. Furthermore, the adjusted tax equivalent basis includes an adjustment that increases interest income on tax-exempt securities and loans by an amount which makes tax-exempt income comparable, on a pre-tax basis, to the Corporation's taxable income. The tax equivalent adjustment declined to \$15.3 million for 2007 from \$28.0 million for 2006 mainly due to the decrease in the interest rate spread on tax-exempt assets resulting from the sustained flatness of the yield curve as well as changes in the proportion of tax-exempt assets to total assets and changes in the statutory income tax rate in Puerto Rico.

Notwithstanding the decrease in adjusted tax equivalent net interest income in absolute terms, the Corporation has been able to maintain its net interest margin on an adjusted tax equivalent basis at a relatively stable level. Net interest margin for the year ended December 31, 2007 was 2.83%, compared to 2.84% for the previous year reflecting the effect of the Corporation's decision to deleverage its balance sheet as well as the effect of the steepened yield curve during the last quarter of 2007. During the second half of 2007 the Corporation sold approximately \$556 million and \$400 million of low-yield mortgage-backed securities and U.S. Treasury investments, respectively, and used the

proceeds in part to pay down high cost borrowings as they matured. The Corporation re-invested approximately \$566 million in higher-yielding U.S. Agency mortgage-backed securities.

**Table of Contents**

The Corporation was able to mitigate the pressure of the sustained flatness of the yield curve during most of 2007 by the redemption of its \$150 million medium-term notes which carried a cost higher than the overall cost of funding and by the increase in the amount of structured repos entered into by the Corporation which price below LIBOR or are structured to lock-in interest rates that are lower than yields on the securities serving as collateral for an extended period.

Total interest income on an adjusted tax equivalent basis decreased by \$105.5 million, mainly due to a decrease in average interest-earning assets. The Corporation's average interest-earning assets decreased by \$1.9 billion or 10% for 2007 compared to 2006. For the investment portfolio, the decrease in average volume was mainly driven by the use of short-term investments to repay short-term brokered CDs as these matured and the sale of low-yield mortgage-backed securities and U.S. government obligations representing a decrease of approximately \$70.0 million in interest income on investments. After receiving the repayment of \$2.4 billion from a local financial institution, the Corporation invested the proceeds in money market investments. During the second half of 2006, the Corporation used a part of the proceeds to repay short-term brokered certificates of deposit, mainly issued in 2006, as these matured. For the loan portfolio, the decrease in average volume, was mainly driven by the aforementioned payment of \$2.4 billion received in 2006 from a local financial institution reducing the balance of a secured commercial loan, partially offset by loan originations that resulted in increases in the average balance of the residential, construction and consumer loan portfolios. Declining loan yields on the Corporation's residential, construction and consumer loan portfolios attributed to the increase in the balance of non-performing loans also adversely affected interest income during 2007.

The Corporation's total interest expense, excluding changes in the fair value of derivatives and the ineffective portion and basis adjustment amortization or accretion, decreased by \$51.0 million or 6% in 2007 compared to 2006. The decrease in interest expense was due to the deleverage of the Corporation's balance sheet by selling low-yielding investment securities and using part of the proceeds to pay down high cost borrowings as they matured. This was partially offset by a higher average cost of borrowings due to higher short-term interest rates experienced during most of 2007 as compared to 2006. During 2007, as compared to 2006, the average volume of deposits decreased by \$1.1 billion and the related average rate increased by 25 basis points, the average volume of other borrowed funds decreased by \$1.1 billion and the related average rate increased by 10 basis points and the average volume of FHLB advances increased by \$450.2 million and the related average rate increased by 31 basis points. The decrease in the average volume of interest-bearing liabilities resulted in a decrease in total interest expense due to volume of \$83.5 million that was partially offset by the increase in the average cost of funds which resulted in an increase in interest expense due to rate of \$32.5 million. The increase in short-term rates also resulted in a change in net payments on interest rate swaps included as part of interest expense. For the year ended December 31, 2007, the net settlement payments on such interest rate swaps resulted in charges of \$12.3 million to total interest expense, compared to charges of \$8.9 million for 2006, as the rates paid under the variable leg of the swaps exceeded the rates received.

**2006 compared to 2005**

Net interest income increased to \$443.7 million for 2006 from \$432.3 million in 2005. The increase in net interest income for the year 2006 as compared to 2005 was mainly driven by a lower net unrealized loss on the valuation changes coupled with the increase in the average volume of interest-earnings assets of \$1.1 billion attributable primarily to the growth in the Corporation's loan and investment portfolios, in particular the construction and residential real estate loan portfolios as well as short-term investments, partially offset by a decrease in net interest margin. Non-cash losses due to the valuation changes amounting to \$58.2 million were recorded in 2006, compared to a net non-cash loss of \$73.4 million in 2005. The reduction in net interest margin on an adjusted tax equivalent basis during 2006 as compared to 2005 was due primarily to increases in short-term interest rates coupled with the mismatch between the re-pricing profile of the Corporation's assets and liabilities. On average, the Corporation's liabilities re-price and/or mature earlier than its assets. Thus, increases in short-term interest rates reduce net interest income, which is an important part of the Corporation's earnings. The decrease in the Corporation's net interest margin was particularly significant with respect to the Corporation's portfolio of

**Table of Contents**

investment securities, excluding money market instruments. Assuming a funding cost equal to the weighted-average cost of the Corporation's other borrowed funds, the interest rate spread on the Corporation's portfolio of investment securities, excluding money market instruments, was approximately 0.64% for the year ended December 31, 2006 compared to 1.90% for the year ended December 31, 2005. For further details on the Corporation's interest rate risk profile, refer to Risk Management Interest Rate Risk Management section of this discussion. The increase in short-term rates also resulted in a change in net payments on interest rate swaps included as part of interest expense. For the year ended December 31, 2006, the net settlement payments on such interest rate swaps resulted in charges of \$8.9 million to interest expense, compared to benefits of \$71.7 million for the year ended December 31, 2005. In addition, net interest income was also affected by the repayment of \$2.4 billion received from a local financial institution during the second quarter of 2006. Proceeds from the repayment were invested temporarily in short-term investments, reducing the Corporation's average yield on interest-earning assets.

On an adjusted tax equivalent basis, net interest income excluding the changes in the fair value of derivative instruments and the ineffective portion and basis adjustment amortization or accretion, decreased by \$37.0 million for 2006 compared to 2005. The decrease in the net interest income for 2006 excluding the changes in the fair value of derivatives, the ineffective portion and basis adjustment, was primarily due to a reduction in the Corporation's net interest margin on an adjusted tax equivalent basis offset in part by increases in the Corporation's average balance of interest-earning assets. The decrease in net interest rate margin during 2006 was due primarily to the upward trend of short-term interest rates, the flattening of the yield curve, and the re-pricing mismatch of the Corporation's assets and liabilities. On average, the Corporation's liabilities re-price and/or mature earlier than its assets. Thus, increases in short-term interest rates reduce net interest income, which is an important part of the Corporation's earnings. The average rate paid by the Corporation on its interest-bearing liabilities increased by 113 basis points during 2006, from 3.58% to 4.71%, mainly due to re-pricing of the Corporation's interest-bearing deposits, mainly from the issuance of brokered CDs at higher rates and from net interest incurred on the interest rate swaps that hedge these instruments, and increases in rates paid on FHLB advances, and other borrowed funds tied to 3-month LIBOR. The average yield earned on the Corporation's interest-earning assets increased by 61 basis points during 2006, from 6.45% to 7.06%, mainly due to the re-pricing of variable rate commercial loans and the origination of new commercial loans at higher rates.

The decrease in net interest margin on an adjusted tax equivalent basis for 2006 was also attributable to the payment of \$2.4 billion received from a local financial institution during the second quarter of 2006 that significantly reduced the Corporation's outstanding secured commercial loan with a local financial institution. Proceeds from the aforementioned repayment were invested temporarily in short-term investment, reducing the Corporation's average yield on interest-earning assets. During the second half of 2006, the Corporation used a substantial amount of the proceeds of the loan repayments to repay higher rate outstanding brokered CDs that matured during the third and fourth quarter of 2006.

The Corporation's average interest-earning assets increased by \$1.1 billion or 6% for 2006 compared to 2005. The increase in average earnings asset was principally due to increases in the Corporation's loan portfolio, mainly in the construction and residential real estate portfolios, and increases in money market investments. Residential real estate loans and construction loans accounted for the largest growth in the portfolio with average volumes rising by \$793.2 million and \$751.5 million, respectively, during 2006 compared to 2005. The Corporation's average volume of the commercial loan portfolio decreased by \$1.6 billion in 2006 compared to 2005. The decrease in the Corporation's commercial loan portfolio was mainly due to the payment from a local financial institution of \$2.4 billion to partially pay down its secured commercial loan with the Corporation. The payment significantly reduced the Corporation's loans-to-one borrower exposure.

For the loan portfolio, the growth in average volume, mainly driven by loan originations, represented a positive increase of \$49.1 million in interest income on loans. The increases due to rate of \$111.8 million are primarily attributable to the origination of new loans at higher rates and to the re-pricing of variable rate loans. The majority of the Corporation's commercial and construction loans are variable rate loans tied to short-term rates indexes. During 2006, the Federal Reserve Bank increased its targeted federal funds rate by 108 basis points, and correspondingly LIBOR and Prime rates also increased. Both indexes are used by the Corporation to re-price the majority of its

floating rate loans including secured loans to local financial institutions (refer to the Financial Condition-Loans Receivable section of this discussion), contributing to higher interest income. As of December 31, 2006, 82% of the commercial and 95% of the construction loan portfolios was variable rate loans.

**Table of Contents**

Average volume increases in the Corporation's investment portfolio contributed to increases in total interest income for 2006. This increase was partially offset by negative rate variances, mainly in government obligations and mortgage-backed portfolios. Average money market investments increased by \$808.4 million. After receiving the repayment of \$2.4 billion from a local financial institution, the Corporation invested the proceeds in money market investments. During the second half of 2006, the Corporation used a part of the proceeds to repay short-term brokered certificates of deposit, mainly issued in 2006, as these matured. The average yield received on money market investments also increased from 3.49% in 2005 to 5.04% in 2006. The increase in yields was due to increases in short-term rates during 2005 and 2006. Average government obligations increased by \$333.5 million, while the average yield decreased by 67 basis points. The increase in average volume and decrease in average yield was due to the re-investment of proceeds from prepayments on securities and larger volume of new investments at lower rates. The average volume and average yield earned on the Corporation's mortgage-backed securities portfolio decreased by \$198.0 million and 54 basis points, respectively, in 2006 compared to 2005. The decrease in the average volume of mortgage-backed securities was due to the Corporation's decision not to reinvest maturities and prepayments received from mortgage-backed securities. Proceeds from prepayments and maturities of mortgage-backed securities were utilized to fund growth in higher yielding loans. The growth in the average balance of investments represented a positive increase in interest income on investments due to volume of \$42.4 million and a negative variance due to rate of \$17.7 million.

The Corporation's total interest expense, excluding changes in the fair value of interest rate swaps and the ineffective portion and basis adjustment amortization or accretion, increased by \$222.6 million or 39% in 2006 compared to 2005. The increase in interest expense was due to higher rates paid on liabilities due to the re-pricing of short-term (i.e., deposits and repurchase agreements) and long-term (i.e., long-term repurchase agreements and other advances) liabilities, net interest incurred on interest rate swap instruments, and increases in the average volume of interest-bearing deposits to support the Corporation's loan and investment portfolio growth. The average volume of deposits increased by \$2.0 billion and the average rate increased by 134 basis points during 2006 compared to 2005, while the average volume of other borrowed funds and FHLB advances decreased by \$458.1 million and \$617.3 million, respectively, and the average rate increased by 76 basis points and 133 basis points, respectively. The increase in the average volume of interest-bearing liabilities coupled with the increase in rates resulted in an increase in interest expense due to volume of \$27.8 million and due to rate of \$194.8 million. The increase in short-term rates also resulted in a change in net payments on interest rate swaps included as part of interest expense. For the year ended December 31, 2006, the net settlement payments on such interest rate swaps resulted in charges of \$8.9 million to interest expense, or a net increase of \$80.6 million in interest expense compared to the previous year, as the rates paid under the variable leg of the swaps exceeded the rates received.

In summary, positive volume variances resulting from an increase in average interest-earning assets were offset by negative rate variances derived from a higher cost of funds, despite higher yields on the loans. The net impact on net interest income and earnings was negative on a rate/volume basis. The Corporation's net interest income (on a tax equivalent basis and excluding changes in the fair value of derivative instruments, the ineffective portion on designated hedges and basis adjustments) decreased by \$37.0 million, the net result of a positive volume variance of \$63.6 million and a negative rate variance of \$100.7 million. The net interest margin decreased from 3.23% for the year 2005 to 2.84% for 2006. The contraction is primarily due to the flat to inverted yield curve and has been particularly significant with respect to the Corporation's portfolio of investment securities, excluding money market instruments.

Net interest income on an adjusted tax equivalent basis for 2006 includes a tax equivalent adjustment of \$28.0 million, compared to an adjustment of \$61.2 million for 2005. The decrease in tax equivalent adjustments was mainly due to a lower interest rate spread on tax-exempt assets.

**Provision for Loan and Lease Losses**

The provision for loan and lease losses is charged to earnings to maintain the allowance for loan and lease losses at a level that the Corporation considers adequate to absorb probable losses currently inherent in the portfolio. The adequacy of the allowance for loan and lease losses is also based upon a number of additional factors including historical loan and lease loss experience, current economic conditions, the fair value of the underlying collateral and

the financial condition of the borrowers, and, as such, includes amounts based on judgments and estimates made by  
58

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**Table of Contents**

the Corporation. Although the Corporation believes that the allowance for loan and lease losses is adequate, factors beyond the Corporation's control, including factors affecting the economies of Puerto Rico, the United States (principally the state of Florida), the U.S. Virgin Islands and the British Virgin Islands may contribute to delinquencies and defaults, thus necessitating additional reserves.

During 2007, the Corporation provided \$120.6 million for loan and lease losses, as compared to \$75.0 million in 2006 and \$50.6 million in 2005.

Refer to the discussions under Risk Management Credit Risk Management Allowance for Loan and Lease Losses and Non-performing Assets below for analysis of the allowance for loan and lease losses and non-performing assets and related ratios.

**2007 compared to 2006**

First BanCorp's provision for loan and lease losses for the year ended December 31, 2007 increased by \$45.6 million, or 61%, compared to year 2006. The increase in the provision was primarily due to deterioration in the credit quality of the Corporation's loan portfolio associated with the weakening economic conditions in Puerto Rico and the slowdown in the United States housing sector. In particular, the increase was mainly related to specific and general provisions related to the Miami Agency construction loan portfolio and increases in the general reserves allocated to the consumer loan portfolio.

During the third quarter of 2007, the Corporation recorded an impairment of \$8.1 million on four condo conversion loans, with an aggregate principal balance of \$60.5 million at the time of the impairment evaluation, extended to a single borrower through the Miami Agency based on an updated impairment analysis that incorporated new appraisals. The increase in non-accrual loans and charge-offs during 2007, other than the aforementioned loan relationship in the Miami Agency, as compared to 2006, was attributable to weak economic conditions in Puerto Rico. Puerto Rico is in the midst of a recession caused by, among other things, higher utilities prices, higher taxes, government budgetary imbalances, the upward trend in short-term interest rates and the flat-to-inverted yield curve, and higher levels of oil prices.

The above-mentioned troubled relationship in the Miami Agency comprised four condo conversion loans that the Corporation had placed in non-accrual status during the second and third quarters of 2007. For the third quarter of 2007, the Corporation updated the impairment analysis on the relationship and requested new appraisals that reflected collateral deficiency as compared to the Corporation's recorded investment in the loans. The aggregate unpaid principal balance of the relationship classified as non-accrual decreased to \$46.4 million as of December 31, 2007, net of a charge-off of \$3.3 million recorded to this relationship in the fourth quarter of 2007. The charge-off was recorded at the time of sale of one of the loans in the relationship with an outstanding principal balance of \$14.1 million at the time of sale. This sale was made at a price of \$10.8 million, which exceeded the recorded investment in the loan (loan receivable less specific reserve) by approximately \$1 million. The Corporation continues to work on different alternatives to decrease the recorded investment in the non-accruing relationship on the Miami Agency.

The Corporation maintains a constant monitoring of the Miami Agency portfolio. Recent loan reviews showed that the Miami Agency construction loan portfolio has an added susceptibility to current general market conditions and real estate trends in the U.S. market due to the oversupply of available property inventory and downward price pressures. Based on these factors and a detailed review of the portfolio, the Corporation determined it was prudent to increase general provisions allocated to this portfolio.

Refer to the discussion under Risk Management Credit Risk Management Allowance for Loan and Lease Losses and Non-performing Assets below for additional information concerning the economy on geographic areas where the Corporation does business and the Corporation's outlook for the performance of its loan portfolio.

Net charge-offs for 2007 were \$88.7 million (0.79% of average loans), compared to \$64.7 million (0.55% of average loans) for 2006. The increase in net charge-offs for the year 2007, compared to 2006, was mainly associated with the Corporation's commercial and construction loan portfolio, as well as its finance lease and consumer loan portfolios due to higher delinquency levels experienced during 2007 and to significantly higher

**Table of Contents**

recoveries on loans during 2006. Included in 2007 is a charge-off of \$3.3 million associated with one of the loans of the previously mentioned impaired condo conversion loan relationship in the Miami Agency. The increase in net charge-offs is primarily the result of the aforementioned deteriorating economic conditions in Puerto Rico and the slowdown in the U.S. housing market. Recoveries made from previously written-off accounts were \$6.1 million and \$12.5 million for 2007 and 2006, respectively.

**2006 compared to 2005**

The Corporation's provision for loan and lease losses increased by \$24.4 million or 48% during 2006 compared to 2005. The increase in the provision principally reflected growth in the Corporation's commercial, excluding loans to local financial institutions, and consumer portfolios, and increasing trends in non-performing loans experienced during 2006 as compared to 2005. The Corporation's net charge-offs and non-performing loans were affected by the fiscal and economic situation of Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico has been in a midst of a recession. The slowdown in activity has been the result of, among other things, higher utilities prices, higher taxes, government budgetary imbalances, the upward trend in short-term interest rates and the flattening of the yield curve, and higher levels of oil prices.

Net charge-offs to average loans outstanding during 2006 were 0.55% as compared to 0.39% in 2005. The provision for loan and lease losses totaled 116% of net charge-offs for 2006, compared with 112% of net charge-offs, for 2005. The increase of \$19.7 million in net charge-offs in 2006, compared with the previous year, was mainly composed of \$24.8 million of higher charge-offs in consumer loans. The increase in net charge-offs in consumer and commercial portfolio was due to the economic situation of the island.

**Table of Contents****Non-Interest Income**

The following table presents the composition of non-interest income:

| <b>Year ended December 31,</b>  | <b>2007</b>            | <b>2006</b>      | <b>2005</b>      |
|---|------------------------|------------------|------------------|
|   | (Dollars in thousands) |                  |                  |
| Other service charges on loans  | \$ 6,893               | \$ 5,945         | \$ 5,431         |
| Service charges on deposit accounts   | 12,769                 | 12,591           | 11,796           |
| Mortgage banking activities   | 2,819                  | 2,259            | 3,798            |
| Rental income   | 2,538                  | 3,264            | 3,463            |
| Insurance income  | 10,877                 | 11,284           | 9,443            |
| Other commissions and fees  | 273                    | 1,470            | 911              |
| Other non-interest income   | 13,322                 | 12,857           | 15,896           |
| Non-interest income before net (loss) gain on investments, insurance reimbursement and other agreements related to a contingency settlement, net gain (loss) on partial extinguishment and recharacterization of secured commercial loans to local financial institutions and gain on sale of credit card portfolio | 49,491                 | 49,670           | 50,738           |
| Net gain on sale of investment  | 3,184                  | 7,057            | 20,713           |
| Impairment on investments   | (5,910)                | (15,251)         | (8,374)          |
| Net (loss) gain on investment   | (2,726)                | (8,194)          | 12,339           |
| Insurance reimbursement and other agreements related to a contingency settlement  | 15,075                 |                  |                  |
| Gain (loss) on partial extinguishment and recharacterization of secured commercial loans to local financial institutions  | 2,497                  | (10,640)         |                  |
| Gain on sale of credit cards portfolio  | 2,819                  | 500              |                  |
| <b>Total</b>  | <b>\$ 67,156</b>       | <b>\$ 31,336</b> | <b>\$ 63,077</b> |

Non-interest income primarily consists of other service charges on loans; service charges on deposit accounts; commissions derived from various banking, securities and insurance activities; gains and losses on mortgage banking activities; and net gains and losses on investments and impairments.

Other service charges on loans consist mainly of service charges on credit card-related activities.

Service charges on deposit accounts include monthly fees and other fees on deposit accounts.

Income from mortgage banking activities includes gains on sales of loans and revenues earned for administering residential mortgage loans originated by the Corporation and subsequently sold with servicing retained. In addition, lower-of-cost-or-market valuation adjustments to the Corporation's residential mortgage loans held for sale portfolio are recorded as part of mortgage banking activities.

Rental income represents income generated by the Corporation's subsidiary, First Leasing and Rental Corporation, on the rental of various types of motor vehicles.

Insurance income consists of insurance commissions earned by the Corporation's subsidiary FirstBank Insurance Agency, Inc., and the Bank's subsidiary in the U.S. Virgin Islands, FirstBank Insurance V.I., Inc. These subsidiaries offer a wide variety of insurance business.

Other commissions and fees income is the result of an agreement with a major investment banking firm to participate in bond issues by the Government Development Bank for Puerto Rico, and an agreement with an

international brokerage firm doing business in Puerto Rico to offer brokerage services in selected branches of the Corporation.

The other non-interest income category is composed of miscellaneous fees such as debit and credit card interchange fees and check fees.

**Table of Contents**

The net gain (loss) on investment securities reflects gains or losses as a result of sales that are consistent with the Corporation's investment policies as well as other-than-temporary impairment charges on the Corporation's investment portfolio.

**2007 compared to 2006**

First BanCorp's non-interest income for 2007 amounted to \$67.2 million, compared to \$31.3 million for 2006. The increase in non-interest income was mainly attributable to income recognition of approximately \$15.1 million for agreements reached with insurance carriers and former executives for reimbursement of expenses related to the settlement of the class action lawsuit brought against the Corporation coupled with lower other-than-temporary impairment charges on certain of the Corporation's equity securities portfolio, as compared to 2006. For 2007, other-than-temporary impairment charges on equity securities decreased by \$9.3 million, as compared to impairment charges recognized for 2006. Also, a net change of \$13.1 million in net gains and losses related to partial repayments of certain secured commercial loans extended to local financial institutions (2007-net gain of \$2.5 million; 2006 net loss of \$10.6 million), a higher gain on the sale of its credit card portfolio and higher income from service charges on loans contributed to the increase in non-interest income during 2007 as compared to 2006.

During 2006, the Corporation recorded a net loss of \$10.6 million on the partial extinguishment of a secured commercial loan extended to a local financial institution as a result of a series of credit agreements reached with Doral Financial Corporation (Doral) to formally document as secured borrowings the loan transfers between the parties that previously had been accounted for erroneously as sales. The terms of the credit agreements specified: (1) a floating interest payment based on a spread over 90-day LIBOR subject to a cap; (2) an amortization schedule tied to the scheduled amortization of the underlying mortgage loans subject to a maximum maturity of 10 years; (3) mandatory prepayments as a result of actual prepayments from the underlying mortgages; and (4) an option to Doral to prepay the loan without penalty at any time.

On May 31, 2006, First BanCorp received a cash payment from Doral, substantially reducing the balance of approximately \$2.9 billion in secured commercial loans to approximately \$450 million as of that date. In connection with the repayment, the Corporation and Doral entered into a sharing agreement on May 25, 2006 with respect to certain profits or losses that Doral would incur as part of the sales of the mortgages that previously collateralized the commercial loans. First BanCorp agreed to reimburse Doral for 40% of the net losses incurred by Doral as a result of sales or securitization of the mortgages, subject to certain conditions and subject to a maximum reimbursement of \$9.5 million, which would be reduced proportionately to the extent that Doral did not sell the mortgages. As a result of the loss sharing agreement and the extinguishment of the secured commercial loans by Doral, the Corporation recorded a net loss of \$10.6 million, composed of losses realized as part of the loss sharing agreement and the difference between the carrying value of the loans and the net payment received from Doral.

In connection with the repayment, Doral and First BanCorp also agreed to share the profits, if any, received from any subsequent sales or securitization of the mortgage loans, in the same proportion that the Corporation shared in the losses, subject to a maximum of \$9.5 million.

During the first quarter of 2007, the Corporation entered into various agreements with 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 banking subsidiary, had outstanding with the Corporation. In addition, the remaining balance of the loans secured by mortgage loans of approximately \$271 million was re-documented as a secured loan from the Corporation to R&G Financial. The terms of the credit agreement specified: (1) a floating interest payment based on a spread over 90-day LIBOR; (2) loan should be payable in arrears in sixty equal consecutive monthly installment of principal (scheduled amortization plus any unscheduled principal recoveries) and interest maturing on February 22, 2012; (3) R&G Financial shall deliver to the Corporation and maintain at all times a first priority security interest with a collateral value as a percentage of loans of 103% for FHA/VA mortgage loans, 105% for conventional conforming mortgage loans and 111% of conventional non-conforming mortgage loans; and (4) R&G Financial may, at its option, prepay the loan without premium or penalty. Second, R&G Financial and the Corporation



**Table of Contents**

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 allow the Corporation to treat these transactions as true sales for accounting and legal purposes and recharacterize the loans as securities collateralized by loans. As a result of the agreements and the partial extinguishment of the secured commercial loan, the Corporation recorded a net gain of \$2.5 million related to the difference between the carrying value of the loans, the net payment received and the fair value of the securities received from R&G Financial.

For the year 2007, the Corporation recorded a gain of \$2.8 million on the sale of the credit card portfolio pursuant to a strategic alliance reached with a U.S. financial institution, compared to a gain of \$0.5 million recorded in 2006.

Higher income from service charges on loans, which increased by \$0.9 million or 16% as compared to 2006, was due to the increase in the loan portfolio volume driven by new originations. Loan originations for 2007 amounted to \$4.1 billion.

**2006 compared to 2005**

For 2006, non-interest income decreased by \$31.7 million as compared to 2005. The decrease in non-interest income for 2006, compared to 2005, was mainly attributable to the above noted net loss of \$10.6 million on the partial extinguishment of a secured commercial loan to a local financial institution, an increase in other-than-temporary impairment charges of \$6.9 million in the Corporation's investment portfolio and lower gains on investments of \$13.7 million. These negative variances were partially offset by increases of \$1.8 million in commission income from the Corporation's insurance business and \$1.3 million in service charges on deposit accounts and loans.

Mortgage banking activities income decreased by \$1.5 million for 2006 compared to 2005. The decrease in 2006 was principally due to a \$1.0 million lower-of-cost-or-market negative valuation adjustment to the Corporation's loans held for sale portfolio as a result of increases in long-term interest rates coupled with a lower volume of mortgage loan sales.

Insurance income for 2006 increased by \$1.8 million or 19% compared to the same period in 2005. The increase for 2006 was due to an increase in the volume of business through cross-selling strategies, marketing efforts and the strategic locations of the Corporation's insurance offices.

Service charges on deposit accounts and other service charges on loans increased by \$0.8 million and \$0.5 million, respectively, during 2006 compared to 2005. The increase for 2006 primarily reflects a larger volume of accounts and transactions during 2006.

Net loss on investments for 2006 amounted to \$8.2 million compared to a net gain of \$12.3 million for the same period in 2005. The decrease in 2006 was principally due to a lower volume of sales coupled with a net increase of \$6.9 million in other-than-temporary impairments in the Corporation's investment portfolio related to certain equity securities. Management concluded that the declines in value of the securities were other-than-temporary, and wrote down the cost basis of these securities to the market value as of the date of the analysis. Management evaluates investment securities for impairment on a quarterly basis or earlier if other factors indicative of potential impairment exist.

**Table of Contents****Non-Interest Expense**

The following table presents the components of non-interest expenses:

| <b>Year ended December 31,</b>              | <b>2007</b>            | <b>2006</b>       | <b>2005</b>       |
|---|------------------------|-------------------|-------------------|
|   | (Dollars in thousands) |                   |                   |
| Employees compensation and benefits         | \$ 140,363             | \$ 127,523        | \$ 102,078        |
| Occupancy and equipment                     | 58,894                 | 54,440            | 47,582            |
| Deposit insurance premium                   | 6,687                  | 1,614             | 1,248             |
| Other taxes, insurance and supervisory fees | 21,293                 | 17,881            | 14,071            |
| Professional fees recurring                 | 13,480                 | 11,455            | 7,317             |
| Professional fees non-recurring             | 7,271                  | 20,640            | 6,070             |
| Servicing and processing fees               | 6,574                  | 7,297             | 6,573             |
| Business promotion                          | 18,029                 | 17,672            | 18,718            |
| Communications                              | 8,562                  | 9,165             | 8,642             |
| Provision for contingencies                 |                        |                   | 82,750            |
| Other                                       | 26,690                 | 20,276            | 20,083            |
| <b>Total</b>                                | <b>\$ 307,843</b>      | <b>\$ 287,963</b> | <b>\$ 315,132</b> |

**2007 compared to 2006**

The Corporation's non-interest expenses for 2007 increased by \$19.9 million, or 7%, compared to 2006. The increase in non-interest expenses was mainly due to increases in employees compensation and benefits as well as deposit insurance premium expenses, occupancy and equipment expenses, other taxes and insurance fees, and other expenses associated with legal contingencies partially offset by a decrease in professional fees.

Employees compensation and benefits expenses for 2007 increased by \$12.8 million, or 10%, compared to 2006. The increase in employees compensation and benefits expenses was primarily due to increases in the average compensation and related fringe benefits paid to employees coupled with the accrual of approximately \$3.3 million for a voluntary separation program established by the Corporation as part of its cost saving strategies.

For the year ended December 31, 2007, the deposit insurance premium expense increased by \$5.1 million, as compared to 2006. The increase in the deposit insurance premium expense was due to changes in the premium calculation adopted by the FDIC during 2007.

Occupancy and equipment expenses for 2007 increased by \$4.5 million, or 8%, compared to 2006. The increase in occupancy and equipment expenses in 2007 is mainly attributable to increases in costs associated with the expansion of the Corporation's branch network and loan origination offices.

Other taxes, insurance and supervisory fees increased by \$3.4 million, or 19%, compared to 2006 due to a higher expense related to prepaid municipal and property taxes recorded during 2007.

For 2007, other expenses increased by \$6.4 million, or 32%, compared to 2006. The increase in other expenses for 2007 was mainly due to a \$3.3 million increase related to costs associated with capital raising efforts in 2007 not qualifying for capitalization coupled with increased costs associated with foreclosure actions on the aforementioned loan relationship at the Miami Agency.

Professional fees decreased during 2007 by \$11.3 million, or 35%, compared to 2006. The decrease was primarily attributable to lower legal, accounting and consulting fees due to the conclusion during the third quarter of 2006 of the internal review conducted by the Corporation's Audit Committee and the restatement process. Further reductions in non-recurring professional service expenses are expected as the Corporation continues to move forward with its business strategies without the distraction of restatement-related matters and legal issues.

**2006 compared to 2005**

Non-interest expense for 2006 decreased by \$27.2 million compared to 2005. Non-interest expense for 2005 includes accruals of \$74.25 million and \$8.5 million for the possible settlement of class action lawsuits and the SEC





**Table of Contents**

investigation, respectively, relating to the Corporation's restatement. Excluding these accruals, non-interest expense during 2006 increased by \$55.6 million compared to 2005. The increase was mainly due to increases in employees compensation and benefits, occupancy and equipment and professional fees.

Employees' compensation and benefits increased in 2006 by \$25.4 million or 25% as compared to 2005. The increase is mainly attributable to increases in average salary and employee benefits and headcount from approximately 2,700 employees as of December 31, 2005, to approximately 3,000 employees as of December 31, 2006. The increase in headcount was mostly attributable to increases associated with the Corporation's loan origination and deposit gathering efforts, in particular at FirstBank Puerto Rico, FirstBank Florida, FirstMortgage, and the Corporation's small loan company as well as increases in support areas, in particular audit and compliance, credit risk management, finance and accounting and information technology and banking operations. The increase was also attributable to the implementation of SFAS 123R and the expensing of the fair value of stock options given to employees. During 2006, the Corporation recorded \$5.4 million in stock-based compensation expense.

Occupancy and equipment expenses increased during 2006 by \$6.9 million or 14% compared to 2005. The increase in occupancy and equipment expenses in 2006 as compared to 2005 is primarily attributable to increases in costs associated with the expansion of the Corporation's branch network and loan origination offices. The increase also reflects higher electricity costs and the additional operating costs from the acquisition of FirstBank Florida.

Other taxes, insurance and supervisory fees increased during 2006 by \$3.8 million or 27% compared to 2005. During 2006, the Corporation experienced increased insurance costs mainly related to increases in rate and coverage of directors' and officers' liability insurance and expensed a higher amount of municipal and property taxes, as compared to 2005.

Professional fees expenses increased during 2006 by \$18.7 million compared to 2005. The increase for 2006 was primarily due to legal, accounting and consulting fees associated with the internal review conducted by the Corporation's Audit Committee as a result of the restatement announcement and other related legal and regulatory proceedings which amounted to \$20.6 million in 2006 compared to \$6.1 million in 2005.

Following the announcement of the Corporation's Audit Committee review, the Corporation and certain of its current and former officers were named as defendants in separate class action suits filed late in 2005. The securities class actions were consolidated. Based on available evidence and discussions with the lead plaintiff, the Corporation accrued \$74.25 million in the 2005 financial statements for a possible settlement of the class action. Subsequently, in 2007, the Corporation resolved the securities class action lawsuit with the approval of the stipulation of settlement filed with the United States District Court for the District of Puerto Rico in the amount of \$74.25 million. The monetary payment was made during the second half of 2007.

In addition, the Corporation held discussions with the staff of the SEC regarding a possible resolution to its investigation of the Corporation's restatement, and accrued \$8.5 million in its consolidated financial statements for the year ended December 31, 2005 in connection with a potential settlement of the SEC's investigation of the Corporation. On August 7, 2007, First BanCorp announced that the SEC approved a final settlement with the Corporation, which resolved the SEC investigation. Under the settlement with the SEC, the Corporation agreed, without admitting or denying any wrongdoing, to be enjoined from future violations of certain provisions of the securities laws. The Corporation also agreed to the payment of an \$8.5 million civil penalty and the disgorgement of \$1 to the SEC. In connection with the settlement, the Corporation consented to the entry of a final judgment to implement the terms of the agreement. The United States District Court for the Southern District of New York must consent to the entry of the final judgment in order to consummate the settlement. The monetary payment was made on October 15, 2007.

**Table of Contents****Income Tax Provision**

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 ( VI ) taxes on its income from sources within the VI 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 FirstBank, which raised the maximum statutory tax rate to 43.5% for taxable years commenced during calendar year 2006. 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 by 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; the percentage is 20% of total net taxable income for taxable years commencing after July 1, 2005.

For additional information relating to income taxes, see Note 25 to the Corporation's audited financial statements.

**2007 compared to 2006**

For the year ended December 31, 2007, the Corporation recognized an income tax expense of \$21.6 million, compared to \$27.4 million in 2006. The decrease in income tax expense was mainly due to lower taxable income coupled with the effect of a lower statutory tax rate in Puerto Rico for 2007 (39% in 2007 compared to 43.5% in 2006). As of December 31, 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 \$4.9 million, compared to a valuation allowance amounting to \$6.1 million as of December 31, 2006. As of December 31, 2007, the deferred tax asset, net of the valuation allowance of \$4.9 million, amounted to approximately \$90.1 million compared to \$162.1 million as of December 31, 2006. The significant decrease in the deferred tax asset is due to the reversal during the third quarter of 2007 of the deferred tax asset related to the class action lawsuit contingency of \$74.25 million recorded as of December 31, 2005 and due to the tax impact of the adoption of SFAS 159, on January 1, 2007, of approximately \$58.7 million. The Corporation reached an agreement with the lead class action plaintiff during 2007 and payments totaling the previously reserve amount of \$74.25 million were made.

**Table of Contents****2006 compared to 2005**

The income tax provision for 2006 increased by \$12.4 million compared to 2005. The increase in 2006 as compared to 2005 was mainly due to a decrease in deferred tax benefits of \$28.5 million mainly due to deferred tax benefits recorded in 2005 related to the possible class action lawsuit settlement that was partially offset by a decrease in the current tax provision due to lower taxable income.

The Corporation evaluated its ability to realize the deferred tax asset and concluded, based on available evidence, that it is more likely than not that some of the deferred tax assets will not be realized and thus, established a valuation allowance of \$6.1 million. As of December 31, 2006, the deferred tax asset, net of the valuation allowance, amounted to approximately \$162.1 million compared to \$130.1 million as of December 31, 2005, including a valuation allowance of \$3.2 million.

The current income tax provision of \$59.2 million in 2006 decreased by \$16.1 million compared to 2005. The decrease in 2006 as compared to 2005 was mainly due to a decrease in taxable income partly offset by a change in the proportion of exempt and taxable income as a result of increases in the Corporation's taxable income generated from the Corporation's loan portfolios and decreases in tax exempt income mainly from the Corporation's investment portfolios and by an increase in non-qualifying IBE income that under current legislation were taxed at regular rates. As discussed above, income from IBEs that operate as a unit of a bank that exceed certain thresholds are taxed at regular income tax rates. The current income tax provision was also impacted by the temporary surtax of 2.0% over FirstBank's net taxable income, explained above, which resulted in an additional income tax provision of \$1.7 million.

The income tax provision includes total deferred income tax benefits of \$31.7 million and \$60.2 million for 2006 and 2005, respectively, which are mainly attributable to temporary differences related to unrealized losses on derivative instruments and class action lawsuit settlement.

**OPERATING SEGMENTS**

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 December 31, 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. For information regarding First BanCorp's reportable segments, please refer to Note 31 Segment Information to the Corporation's financial statements for the year ended December 31, 2007 included in Item 8 of this Form 10-K.

The accounting policies of the segments are the same as those described in Note 1 Nature of Business and Summary of Significant Accounting Policies to the Corporation's audited financial statements for the year ended December 31, 2007 included in Item 8 of this 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.

**Table of Contents**

The Treasury and Investment segment loans funds to the Consumer (Retail) Banking, Mortgage Banking and Commercial and Corporate Banking segments to finance their lending activities and borrows funds from those segments. The Consumer (Retail) Banking segment also loans funds to other segments. The interest rates charged or credited by Treasury and Investment and the Consumer (Retail) Banking 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.

*Consumer (Retail) Banking*

The Consumer (Retail) Banking segment consists of the Corporation's consumer lending and deposit-taking activities conducted mainly through its branch network and loan centers. Loans to consumers include auto, credit card and personal loans. Deposit products include checking and savings accounts, Individual Retirement Accounts (IRA) and retail certificates of deposit. Retail deposits gathered through each branch of FirstBank's retail network serve as one of the funding sources for the lending and investment activities.

Consumer lending growth has been mainly driven by auto loan originations. The growth of these portfolios has been achieved through a strategy of providing outstanding service to selected auto dealers that provide the channel for the bulk of the Corporation's auto loan originations. This strategy is directly linked to our commercial lending activities as the Corporation maintains strong and stable auto floor plan relationships, which are the foundation of a successful auto loan generation operation. The Corporation continues to strengthen the commercial relations with floor plan dealers, which directly benefit the Corporation's consumer lending operation and are managed as part of the consumer banking activities.

Personal loans and, to a lesser extent, marine financing and a small credit card portfolio also contribute to interest income generated on consumer lending. Management plans to continue to be active in the consumer loans market, applying the Corporation's strict underwriting standards.

The highlights of the Consumer (Retail) Banking segment financial results for the year ended December 31, 2007 include the following:

Segment income before taxes for the year ended December 31, 2007 was \$82.9 million compared to \$139.6 million and \$112.5 million for the years ended December 31, 2006 and 2005, respectively.

Net interest income for the year ended December 31, 2007 was \$205.3 million compared to \$238.5 million and \$200.8 million for the years ended December 31, 2006 and 2005, respectively. The decrease in net interest income for the year 2007 as compared to 2006 was primarily attributable to a decrease in the average of interest-earning assets due to principal repayments and charge-offs relating to the auto and personal loans portfolio coupled with the sale of approximately \$15.6 million during 2007 of the Corporation's credit card portfolio. The increase for 2006 compared to 2005 was mainly driven by the increase in the average volume of interest-earning assets primarily due to new loan originations, in particular increases in the auto and personal loans portfolio.

The provision for loan and lease losses for the year 2007 increased by \$20.2 million compared to the same period in 2006 and \$1.5 million when comparing 2006 with the same period in 2005. The increase in the provision for loan and lease losses was mainly due to a higher general reserve for the Puerto Rico consumer loan portfolio, particularly auto loans, as a result of weak economic conditions in Puerto Rico. Increasing trends in non-performing loans and charge-offs experienced during 2007 and 2006 were affected by the fiscal and economic situation of Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico has been in a midst of a recession since the third quarter of 2005. The slowdown in activity is the result of, among other things, higher utilities prices, higher taxes, government budgetary imbalances, the upward trend in short-term interest rates and the flattening of the yield curve, and higher levels of oil prices.

Non-interest income for the year ended December 31, 2007 was \$27.3 million compared to \$23.5 million and \$23.1 million for the years ended December 31, 2006 and 2005, respectively. The



**Table of Contents**

increase in non-interest income for 2007, as compared to 2006, was driven by a gain on sale of a credit card portfolio of \$2.8 million resulted from a portfolio sold pursuant to a strategic alliance agreement reached with a U.S. financial institution.

Direct non-interest expenses for the year ended December 31, 2007 were \$94.1 million compared to \$86.9 million and \$77.3 million for the years ended December 31, 2006 and 2005, respectively. The increase in direct operating expense for 2007 and 2006 was mainly due to increases in employees' compensation and benefits and occupancy and equipment. The increase in employees' compensation and benefits was mainly from increases in the headcount in the Corporation's retail bank branch network coupled with increases in average salary and employee benefits to support the growth of the segment.

*Commercial and Corporate Banking*

The Commercial and Corporate Banking segment consists of the Corporation's lending and other services for the public sector and specialized industries such as healthcare, tourism, financial institutions, food and beverage, shopping centers 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. A substantial portion of this portfolio is secured by commercial real estate. Although commercial loans involve greater credit risk because they are larger in size and more risk is concentrated in a single borrower, the Corporation has and maintains an effective credit risk management infrastructure designed to mitigate potential losses associated with commercial lending, including strong underwriting and loan review functions, sales of loan participations and continuous monitoring of concentrations within portfolios.

For this segment, the Corporation follows a strategy aimed to cater to customer needs in the commercial loans middle market segment by building strong relationships and offering financial solutions that meet customers' unique needs. Starting in 2005, the Corporation expanded its distribution network and participation in the commercial loans middle market segment by focusing on customers with financing needs up to \$5 million. The Corporation established 5 regional offices that provide coverage throughout Puerto Rico. The offices are staffed with sales, marketing and credit officers able to provide a high level of personalized service and prompt decision-making.

The highlights of the Commercial and Corporate Banking segment financial results for the year ended December 31, 2007 include the following:

Segment income before taxes for the year ended December 31, 2007 was \$77.8 million compared to \$123.8 million and \$145.9 million for the years ended December 31, 2006 and 2005, respectively.

Net interest income for the year ended December 31, 2007 was \$135.9 million compared to \$154.7 million and \$153.5 million for the years ended December 31, 2006 and 2005, respectively. The decrease in net interest income for the year 2007 was mainly driven by a decrease in the average volume of interest-earning assets. The decrease in the segment's average volume of interest-earning assets was mainly due to the substantial partial repayment of \$2.4 billion received from Doral in May 2006 that reduced the segment's outstanding secured commercial loan from local financial institutions. The repayment also reduced the Corporation's loans-to-one borrower exposure. The slight increase in net interest income in 2006 as compared to 2005 is mainly attributable to an increase in net interest margin due to the increase in short-term rates. The majority of the Corporation's commercial and construction loans are variable rate loans tied to short-term indexes. During 2006, the Federal Reserve Bank increased its targeted federal funds rate by 108 basis points, and, correspondingly, LIBOR and Prime rates also increased.

The provision for loan and lease losses for the year 2007 was \$41.2 million compared to \$7.9 million and \$2.7 million for the years 2006 and 2005, respectively. The increase in the provision for loan and lease losses for 2007, compared to 2006, was mainly driven by higher general and specific reserves relating to the Miami Agency construction loan portfolio due to the slowdown of the U.S. housing market, an \$8.1 million charge due to the collateral impairment on the previously discussed troubled loan relationship in the Miami Agency, and to the increase in the loan portfolio. The increase for





**Table of Contents**

2006, compared to 2005, was primarily attributable to the growth in the Corporation's commercial portfolio coupled with increasing trends in non-performing loans and charge-offs experienced during 2006.

Total non-interest income for the year ended December 31, 2007 amounted to \$6.3 million compared to a non-interest loss of \$6.1 million and non-interest income of \$5.6 million for the years ended December 31, 2006 and 2005 respectively. The fluctuation in non-interest income for 2007, as compared to 2006, and 2006 as compared to 2005, was mainly attributable to the net loss of \$10.6 million on the partial extinguishment of a secured commercial loan to a local financial institution, recorded in 2006.

Direct non-interest expenses for 2007 were \$23.2 million compared to \$16.9 million and \$10.5 million for 2006 and 2005, respectively. The increase in direct operating expense for 2007, as compared to 2006, was mainly from increases in employees' compensation due to increases in average salary and employee benefits and increases in foreclosure related expenses associated with the impaired loans in the Miami Agency coupled with the expense allocated to this segment related to the FDIC insurance premium expense. The increase for 2006, as compared to 2005, was driven by increases in employees' compensation and benefits primarily due to the full deployment of the Corporation's middle-market business strategy and increases in average salary and employee benefits to support the growth of the segment. The staffing of the middle market regional offices was done during 2005 with the full year salary expense effect in 2006.

*Mortgage Banking*

The Mortgage Banking segment conducts its operations mainly through FirstBank and its mortgage origination subsidiary, FirstMortgage. These operations consist of the origination, sale and servicing of a variety of residential mortgage loans products. Originations are sourced through different channels such as branches, mortgage brokers, real estate brokers, and in association with new project developers. FirstMortgage focuses on originating residential real estate loans, some of which conform to Federal Housing Administration (FHA), Veterans Administration (VA) and Rural Development (RD) standards. Loans originated that meet FHA standards qualify for the federal agency's insurance program whereas loans that meet VA and RD standards are guaranteed by their respective federal agencies. Mortgage loans that do not qualify under these programs are commonly referred to as conventional loans. Conventional real estate loans could be conforming and non-conforming. Conforming loans are residential real estate loans that meet the standards for sale under the Fannie Mae and Freddie Mac programs whereas loans that do not meet the standards are referred to as non-conforming residential real estate loans. The Corporation's strategy is to penetrate markets by providing customers with a variety of high quality mortgage products to serve their financial needs faster, simpler and at competitive prices.

The Mortgage Banking segment also acquires and sells mortgages in the secondary markets. From time to time, residential real estate conventional conforming loans are directly sold to Fannie Mae and Freddie Mac, or are grouped into pools of \$1 million or more in aggregate principal balance and exchanged for Fannie Mae or Freddie Mac-issued mortgage-backed securities, which the Corporation sells to investors.

The highlights of the Mortgage Banking segment financial results for the year ended December 31, 2007 include the following:

Segment income before taxes for the year ended December 31, 2007 was \$18.6 million compared to \$24.4 million and \$25.5 million for the years ended December 31, 2006 and 2005, respectively.

Net interest income for the year ended December 31, 2007 was \$39.0 million compared to \$43.4 million and \$39.0 million for the years ended December 31, 2006 and 2005, respectively. The decrease in net interest income for 2007, as compared to 2006, was principally due to declining loan yields on the residential mortgage loan portfolio resulting from the increase in non-performing loans. The increase in net interest income for the year 2006, as compared to 2005, was mainly driven by the increase in the average outstanding balance of mortgage loans, partially offset by a reduction in net

**Table of Contents**

interest margin due to the flattening of the yield curve and by a significantly higher balance of non-accruing loans.

The provision for loan and lease losses for the year 2007 was \$1.6 million compared to \$4.0 million and \$2.1 million for the years ended December 31, 2006 and 2005, respectively. The decrease in 2007, as compared to 2006, was due to the fact that in 2006 after a detailed review of the residential mortgage loan portfolio the Corporation determined that it was needed to increase its allowance for loan and lease losses based on the deterioration of the economic conditions in Puerto Rico and the increase in the home price index in Puerto Rico. The Corporation continues to update the analysis on a yearly basis, the latest being in March 2007 when the Corporation obtained similar results. As a consequence, the Corporation determines that the allowance for loan losses for the residential mortgage loan portfolio is maintained at an adequate level. The increase in the provision for loan and lease losses for 2006, as compared to 2005, was mainly due to growth in the segment's portfolio coupled with increasing trends in non-performing loans and revisions to the allowance based on deteriorating economic conditions.

Non-interest income for the year ended December 31, 2007 was \$3.0 million compared to \$2.5 million and \$3.9 million for the years ended December 31, 2006 and 2005, respectively. The increase for 2007 was driven by higher service charges on loans associated with the growth in the residential mortgage loans portfolio coupled with a negative lower-of-cost-or-market adjustment of \$1.0 million recorded in 2006 to the loans-held-for-sale portfolio. This negative adjustment, resulting from increases in long-term rates, was the main reason for the decrease in non-interest income for 2006 as compared to 2005.

Direct non-interest expenses for 2007 were \$21.8 million compared to \$17.5 million and \$15.4 million for the years 2006 and 2005, respectively. The increase in direct operating expense for 2007 was mainly due to increases in employees' average salary compensation and higher employer benefits. The Corporation continued to commit substantial resources to this segment with the goal of becoming a leading institution in the highly competitive residential mortgage loans market.

*Treasury and Investments*

The Treasury and Investments segment is responsible for the Corporation's investment portfolio and treasury functions designed to manage and enhance liquidity. This segment sells funds to the Commercial and Corporate Banking, Mortgage Banking, and Consumer (Retail) Banking segments to finance their lending activities and also purchases funds gathered by those segments. The interest rates charged or credited by Treasury and Investments are based on market rates.

The highlights of the Treasury and Investments segment financial results for the year ended December 31, 2007 include the following:

Segment loss before taxes for the year ended December 31, 2007 amounted to \$14.5 million compared to a loss of \$79.2 million and a loss of \$12.8 million for the years ended December 31, 2006 and 2005, respectively.

Net interest loss for the year ended December 31, 2007 was \$4.5 million compared to a loss of \$63.2 million and a loss of \$20.7 million for the years ended December 31, 2006 and 2005, respectively. The lower net interest loss for 2007 was caused by the effect in 2006 earnings of non-cash losses from changes in the fair value of derivative instruments prior to the implementation of the long-haul method of accounting on April 3, 2006. During the first quarter of 2006, the Corporation recorded unrealized losses of \$69.7 million for non-hedge derivatives as part of interest expense. The adoption of fair value hedge accounting in the second quarter of 2006 and the adoption of SFAS 159 in 2007 reduced the accounting volatility that previously resulted from the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. The increase in net interest loss for the year 2006, as compared to 2005, was mainly driven by negative changes in the valuation of derivative instruments, mainly

interest rate swaps that hedge designated and undesignated brokered CDs in 2006, changes in  
71

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**Table of Contents**

net payments on interest rate swaps included as part of interest expense, and a reduction in net interest margin due to the flattening of the yield curve. The decrease in net interest margin for 2006 was also attributable to the payment of \$2.4 billion received from a local financial institution. Proceeds from the repayment were invested temporarily in short-term investments at zero or negative margin, reducing the segment's net interest margin. During the second half of 2006, the Corporation used a part of the repayment proceeds to repay higher rate outstanding brokered CDs that matured.

Non-interest loss for the year ended December 31, 2007 amounted to \$2.2 million compared to a loss of \$8.3 million and non-interest income of \$12.9 million for the years ended December 31, 2006 and 2005, respectively. The decrease in non-interest loss for 2007 was driven by lower other-than-temporary impairment charges in the Corporation's equity securities portfolio, which decreased by \$9.3 million as compared to 2006. The decrease in non-interest income for 2006 was mainly attributable to an increase in other-than-temporary impairment charges of \$6.9 million in the Corporation's investment portfolio when compared to 2005.

Direct non-interest expenses for 2007 were \$7.8 million compared to \$7.7 million and \$5.0 million for the years 2006 and 2005, respectively. The increase in direct operating expense for 2007 and 2006 was mainly due to increases in employees' compensation and benefits.

**Table of Contents****FINANCIAL CONDITION AND OPERATING DATA ANALYSIS****Financial Condition**

The following table presents an average balance sheet of the Corporation for the following years:

| <b>December 31,</b>                               | <b>2007</b>          | <b>2006</b><br>(Dollars in<br>thousands) | <b>2005</b>          |
|---|----------------------|--|----------------------|
| <b>Assets</b>                                     |                      |  |                      |
| Interest-earning assets:                          |                      |  |                      |
| Money market investments                          | \$ 440,598           | \$ 1,444,533                             | \$ 636,114           |
| Government obligations                            | 2,687,013            | 2,827,196                                | 2,493,725            |
| Mortgage-backed securities                        | 2,296,855            | 2,540,394                                | 2,738,388            |
| Corporate bonds                                   | 7,711                | 8,347                                    | 48,311               |
| FHLB stock  | 46,291               | 26,914                                   | 71,588               |
| Equity securities                                 | 8,133                | 27,155                                   | 50,784               |
| <b>Total investments</b>                          | <b>5,486,601</b>     | <b>6,874,539</b>                         | <b>6,038,910</b>     |
| Residential real estate loans                     | 2,914,626            | 2,606,664                                | 1,813,506            |
| Construction loans                                | 1,467,621            | 1,462,239                                | 710,753              |
| Commercial loans                                  | 4,797,440            | 5,593,018                                | 7,171,366            |
| Finance leases                                    | 379,510              | 322,431                                  | 243,384              |
| Consumer loans                                    | 1,729,548            | 1,783,384                                | 1,570,468            |
| <b>Total loans</b>                                | <b>11,288,745</b>    | <b>11,767,736</b>                        | <b>11,509,477</b>    |
| <b>Total interest-earning assets</b>              | <b>16,775,346</b>    | <b>18,642,275</b>                        | <b>17,548,387</b>    |
| <b>Total non-interest-earning assets (1)</b>      | <b>438,861</b>       | <b>540,636</b>                           | <b>452,652</b>       |
| <b>Total assets</b>                               | <b>\$ 17,214,207</b> | <b>\$ 19,182,911</b>                     | <b>\$ 18,001,039</b> |
| <b>Liabilities and stockholders equity</b>        |                      |  |                      |
| Interest-bearing liabilities:                     |                      |  |                      |
| Interest-bearing checking accounts                | \$ 443,420           | \$ 371,422                               | \$ 376,360           |
| Savings accounts                                  | 1,020,399            | 1,022,686                                | 1,092,938            |
| Certificates of deposit                           | 9,291,900            | 10,479,500                               | 8,386,463            |
| <b>Interest bearing deposits</b>                  | <b>10,755,719</b>    | <b>11,873,608</b>                        | <b>9,855,761</b>     |
| Other borrowed funds                              | 3,449,492            | 4,543,262                                | 5,001,384            |
| FHLB advances                                     | 723,596              | 273,395                                  | 890,680              |
| <b>Total interest-bearing liabilities</b>         | <b>14,928,807</b>    | <b>16,690,265</b>                        | <b>15,747,825</b>    |
| <b>Total non-interest-bearing liabilities (2)</b> | <b>959,361</b>       | <b>1,294,563</b>                         | <b>976,705</b>       |
| <b>Total liabilities</b>                          | <b>15,888,168</b>    | <b>17,984,828</b>                        | <b>16,724,530</b>    |
| Stockholders equity:                              |                      |  |                      |
| Preferred stock                                   | 550,100              | 550,100                                  | 550,100              |
| Common stockholders equity                        | 775,939              | 647,983                                  | 726,409              |
| <b>Stockholders equity</b>                        | <b>1,326,039</b>     | <b>1,198,083</b>                         | <b>1,276,509</b>     |

|   |               |    |            |               |
|---|---------------|----|------------|---------------|
| Total liabilities and stockholders equity | \$ 17,214,207 | \$ | 19,182,911 | \$ 18,001,039 |
|---|---------------|----|------------|---------------|

(1) Includes the allowance for loan losses and the valuation on investment securities available-for-sale.

(2) Includes changes in fair value on liabilities elected to be measured at fair value under SFAS 159.

The Corporation's total average assets were \$17.2 billion and \$19.2 billion as of December 31, 2007 and 2006, respectively; a decrease for 2007 of \$2.0 billion or 10% as compared to 2006. The decrease in average assets was due to deleveraging of the balance sheet. In particular, the Corporation made use of short-term money market investments to pay down brokered certificates deposits and repurchase agreements as they matured and sold lower yielding U.S. Treasury and mortgage-backed securities. The average balance of the commercial loan portfolio decreased by \$795.6 million due to the repayment of \$2.4 billion received from a local financial institution in May 2006 and the partial extinguishment of \$50 million and the recharacterization of approximately \$183.8 million of secured commercial loans extended to R&G Financial in February 2007. As of December 31, 2006, the increase in average assets compared to 2005 was mainly due to: (1) an increase of \$808.4 million in money market instruments due to the repayment of \$2.4 billion received from a local financial institution that was temporarily invested in short-term investments; (2) an increase of \$793.2 million in residential real estate loans; (3) an increase of \$751.5 million in construction loans; and (4) an increase of \$212.9 million in consumer loans. These positive variances were

**Table of Contents**

partially offset by a decrease of \$1.6 billion in commercial loans mainly due to the repayment of \$2.4 billion received from a local financial institution in May 2006.

The Corporation's total average liabilities were \$15.9 billion and \$18.0 billion as of December 31, 2007 and 2006, respectively, a decrease of \$2.1 billion or 12% as compared to 2006. The decrease in average liabilities for 2007, as compared to 2006, was driven by a lower average balance of brokered CDs and repurchase agreements due to the deleveraging of the Corporation's balance sheet. In addition, the redemption of the Corporation's \$150 million medium-term notes during the second quarter of 2007, which carried a cost higher than the overall cost of funding, contributed to the decrease in average liabilities in 2007. These reductions were partially offset by a higher average volume of advances from FHLB.

As of December 31, 2006, the increase in average liabilities compared to 2005 was mainly due to increases in brokered CDs partially offset by decreases in other borrowed funds and FHLB advances. The increase in brokered CDs and decrease in FHLB advances was partly due to the Corporation's decision to replace FHLB advances as these matured since the collateral was under evaluation. During 2005, the FHLB evaluated the eligibility of collateral that secured the commercial loans to local financial institutions and concluded that such collateral was not eligible to secure advances from the FHLB.

**Assets**

The Corporation's total assets as of December 31, 2007 amounted to \$17.2 billion as compared to \$17.4 billion as of December 31, 2006, a decrease of \$203.3 million. The decrease in total assets as of December 31, 2007, compared to total assets as of December 31, 2006, resulted from an overall decrease in investment securities. As previously noted, the Corporation, as part of its strategy, has deleveraged its balance sheet by selling lower yield investments securities to pay down and retire higher cost brokered CDs and repurchase agreements as they matured. For the year 2007 approximately \$956 million of lower yielding U.S. Treasury bonds and mortgage-backed securities were sold, of which approximately \$566 million were opportunistically re-invested in higher yielding U.S. Agency mortgage-backed securities. Furthermore, the Corporation's deferred tax asset decreased by \$72.0 million in 2007 due to the effect of the adoption of SFAS 159 on January 1, 2007 in the amount of approximately \$58.7 million and a reversal related to the class action settlement paid in 2007.

**Loans Receivable**

The following table presents the composition of the loan portfolio including loans held for sale as of year-end for each of the last five years.

| <b>December 31,</b>  | <b>2007</b>            | <b>2006</b>  | <b>2005</b>  | <b>2004</b>  | <b>2003</b>  |
|--|------------------------|--------------|--------------|--------------|--------------|
|  | (Dollars in thousands) |              |              |              |              |
| Residential real estate loans, including loans held for sale   | \$ 3,164,421           | \$ 2,772,630 | \$ 2,346,945 | \$ 1,322,650 | \$ 1,023,188 |
| Commercial mortgage  | 1,279,251              | 1,215,040    | 1,090,193    | 690,900      | 683,766      |
| Construction loans   | 1,454,644              | 1,511,608    | 1,137,118    | 398,453      | 328,175      |
| Commercial loans   | 3,231,126              | 2,698,141    | 2,421,219    | 1,871,851    | 1,623,964    |
| Commercial loans to local financial institutions collateralized by real estate mortgages and pass-through trust certificates | 624,597                | 932,013      | 3,676,314    | 3,841,908    | 2,061,437    |
| Total commercial loans   | 6,589,618              | 6,356,802    | 8,324,844    | 6,803,112    | 4,697,342    |
| Finance leases   | 378,556                | 361,631      | 280,571      | 212,234      | 159,696      |
| Consumer loans   | 1,667,151              | 1,772,917    | 1,733,569    | 1,359,998    | 1,160,829    |
| Total loans, gross   | 11,799,746             | 11,263,980   | 12,685,929   | 9,697,994    | 7,041,055    |

|                                     |               |               |               |              |              |
|-------------------------------------|---------------|---------------|---------------|--------------|--------------|
| Less:                               |               |               |               |              |              |
| Allowance for loan and lease losses | (190,168)     | (158,296)     | (147,999)     | (141,036)    | (126,378)    |
| Total loans, net                    | \$ 11,609,578 | \$ 11,105,684 | \$ 12,537,930 | \$ 9,556,958 | \$ 6,914,677 |





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|   |               |               |               |              |              |
|---|---------------|---------------|---------------|--------------|--------------|
| Finance leases originated               | 139,599       | 177,390       | 145,808       | 116,200      | 67,332       |
| Consumer loans originated and purchased | 653,180       | 807,979       | 992,942       | 746,113      | 583,083      |
| Total loans originated and purchased    | 4,084,143     | 4,887,590     | 6,512,978     | 5,179,854    | 3,640,296    |
| Sales and securitizations of loans      | (147,044)     | (167,381)     | (118,527)     | (180,818)    | (228,824)    |
| Repayments and prepayments              | (3,084,530)   | (6,022,633)   | (3,803,804)   | (2,263,043)  | (1,938,301)  |
| Other (decreases) increases (1)(2)      | (348,675)     | (129,822)     | 390,325       | (93,712)     | (81,605)     |
| Net increase (decrease)                 | 503,894       | (1,432,246)   | 2,980,972     | 2,642,281    | 1,391,566    |
| Ending balance                          | \$ 11,609,578 | \$ 11,105,684 | \$ 12,537,930 | \$ 9,556,958 | \$ 6,914,677 |
| Percentage increase (decrease)          | 4.54%         | -11.42%       | 31.19%        | 38.21%       | 25.20%       |

(1) Includes the change in the allowance for loan and lease losses and cancellation of loans due to the repossession of the collateral.

(2) For 2007, includes the recharacterization of securities collateralized by loans of approximately \$183.8 million previously accounted for as a secured commercial loan with R&G Financial. For 2005, includes \$470 million of loans acquired as part of the Ponce General acquisition.

**Table of Contents****Residential Real Estate Loans**

Residential real estate loan production and purchases for the year ended December 31, 2007 decreased by \$193.6 million, compared to the same period in 2006 and decreased by \$463.6 million, compared to the same period in 2005. The decrease in mortgage loan production was attributable to deteriorating economic conditions in Puerto Rico, the slowdown in the United States housing market and stricter underwriting standards. The Corporation decided to make certain adjustments to its underwriting standards designed to enhance the credit quality of its mortgage loan portfolio, in light of worsening macroeconomic conditions in Puerto Rico. The Corporation's residential real estate loan portfolio is primarily composed of fully amortizing fixed-rate loans. In accordance with the Corporation's underwriting guidelines, residential real estate loans are fully documented loans and the Corporation is not actively involved in the origination of negative amortization loans or option adjustable rate mortgage loans.

Residential real estate loans represent 18% of total loans originated and purchased for 2007, with the residential mortgage loans balance increasing by \$391.8 million, from \$2.8 billion in 2006 to \$3.2 billion in 2007. The Corporation's strategy is to penetrate markets by providing customers with a variety of high quality mortgage products. The Corporation's residential mortgage loan originations continued to be driven by FirstMortgage. The Corporation continued to commit substantial resources to this operation with the goal of becoming a leading institution in the highly competitive residential mortgage loans market. The Corporation established FirstMortgage as a stand-alone subsidiary in 2003. As of December 31, 2007, FirstMortgage had a distribution network of 26 mortgage centers, including stand-alone centers and offices located within FirstBank Puerto Rico branches. FirstMortgage supplements its internal direct originations through its retail network with an indirect business strategy. The Corporation's Partners in Business, a division of FirstMortgage, partners with mortgage brokers in Puerto Rico to purchase ongoing mortgage loan production. FirstMortgage Realty Group, launched in 2005, focuses on building relationships with realtors by providing resources, office amenities and personnel, to assist real estate brokers in building their individual businesses and closing transactions. FirstMortgage's multi-channel strategy has proven to be effective in capturing business.

**Commercial and Construction Loans**

In recent years, the Corporation has emphasized commercial lending activities and continues to penetrate this market. A substantial portion of this portfolio is collateralized by real estate. Total commercial loans originated and purchased amounted to \$2.6 billion for 2007, a decrease of \$417.2 million when compared to originations during 2006, for total commercial loans portfolio of \$6.6 billion at December 31, 2007. As a result of new originations net of prepayments and maturities, the commercial loans balance, excluding secured commercial loans to local financial institutions, increased by \$0.5 billion, from \$5.4 billion as of December 31, 2006 to \$6.0 billion as of December 31, 2007.

The decrease in commercial and construction loan production for 2007, compared to 2006, was mainly due to adverse economic conditions in Puerto Rico and in the U.S. real estate market (principally in the state of Florida) and the implementation of stricter underwriting standards. According to the Puerto Rico Planning Board, Puerto Rico has been in a midst of a recession, causing a slowdown in the commercial business activity. The U.S. mainland real estate market also has slowed, influenced, among other things, by declining home prices and an oversupply of available property inventory. Increases in property insurance premiums along with rising gas prices are also affecting the areas in which the Corporation does business in the U.S. mainland. Also, since the third quarter of 2006, the Corporation decided to limit the origination and reduce the exposure of condo conversion loans in the U.S. mainland. As a result, the condo conversion loan portfolio decreased from its peak in May 2006 of approximately \$653 million to approximately \$305 million as of December 31, 2007.

Although commercial loans involve greater credit risk because they are larger in size and more risk is concentrated in a single borrower, the Corporation has and continues to develop an effective credit risk management

**Table of Contents**

infrastructure that mitigates potential losses associated with commercial lending, including strong underwriting and loan review functions, sales of loan participations, and continuous monitoring of concentrations within portfolios.

The Corporation's commercial loans are primarily variable and adjustable rate loans. Commercial loan originations come from existing customers as well as through referrals and direct solicitations. The Corporation follows a strategy aimed to cater to customer needs in the commercial loans middle-market segment by building strong relationships and offering financial solutions that meet customers' unique needs. Starting in 2005, the Corporation expanded its distribution network and participation in the commercial loans middle market segment by focusing on customers with financing needs in amounts up to \$5 million. The Corporation established 5 regional offices that provide coverage throughout Puerto Rico. The offices are staffed with sales, marketing and credit officers able to provide a high level of personalized service and prompt decision-making.

The Corporation has a significant lending concentration of \$382.6 million in one mortgage originator in Puerto Rico, Doral, as of December 31, 2007. The Corporation has outstanding \$242.0 million with another mortgage originator in Puerto Rico, R&G Financial, for total loans to mortgage originators amounting to \$624.6 million as of December 31, 2007. These commercial loans are secured by individual mortgage loans on residential and commercial real estate. In December 2005, the Corporation obtained a waiver from the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico with respect to the statutory limit for individual borrowers (loan to one borrower limit). In May 2006, FirstBank Puerto Rico received a cash payment from Doral of approximately \$2.4 billion, substantially reducing the balance of the secured commercial loan extended to that institution. The Corporation has continued working on the reduction of these exposures with both financial institutions.

As previously discussed, the execution of the agreements entered into with R&G Financial during 2007 enabled First BanCorp 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 previously accounted for as commercial loans secured by mortgage loans and pass-through trust certificates.

**Consumer Loans**

Consumer loan originations and purchases are principally driven through the Corporation's retail network. For the year ended December 31, 2007, consumer loan originations amounted to \$653.2 million, a decrease of \$154.8 million or 19% compared to the same period in 2006. The decrease in consumer loan originations was attributable to a lower volume of business resulting from adverse economic conditions of Puerto Rico coupled with stricter underwriting standards put in place to improve the credit quality of the portfolio. The decrease of \$105.8 million in the consumer loan balance as of December 31, 2007, compared to the balance as of December 31, 2006, was due to principal repayments, higher charge-offs and the sale of approximately \$15.6 million of the Corporation's credit card portfolio pursuant to a strategic alliance agreement reached with a U.S. financial institution. Consumer loan originations are driven by auto loan originations through a strategy of providing outstanding service to selected auto dealers who provide the channel for the bulk of the Corporation's auto loan originations. This strategy is directly linked to our commercial lending activities as the Corporation maintains strong and stable auto floor plan relationships, which are the foundation of a successful auto loan generation operation. The Corporation will continue to strengthen the commercial relations with floor plan dealers, which directly benefit the Corporation's consumer lending operation.

**Finance Leases**

Originations of finance leases, which are mostly composed of loans to individuals to finance the acquisition of motor vehicles, decreased by \$37.8 million or 21% to \$139.6 million during 2007 compared to 2006. Driven by new originations the portfolio balance increased by \$16.9 million in 2007. These leases typically have five-year terms and are collateralized by a security interest in the underlying assets. The Corporation exposure to operating leases is minimal.

**Table of Contents****Investment Activities**

The Corporation's investment portfolio as of December 31, 2007 amounted to \$4.8 billion, a decrease of \$732.8 million when compared with the investment portfolio of \$5.5 billion as of December 31, 2006. The decrease in investment securities resulted mainly from prepayments and maturities received from the Corporation's investment portfolio coupled with the sale of low-yield U.S. Treasury and mortgage-backed securities during 2007 consistent with the Corporation's decision to deleverage the balance sheet. For the year 2007, approximately \$956 million of lower yielding U.S. Treasury bonds and mortgage-backed securities were sold, of which approximately \$566 million were opportunistically re-invested in higher yielding U.S. Agency mortgage-backed securities. The Corporation's decision to deleverage its balance sheet was influenced, among other things, by the flat to inverted yield curve and to protect net interest margin. As a result, the Corporation decided to repay higher rate maturing liabilities, in particular brokered CDs, and repurchase agreements as they matured.

Total purchases of investment securities, excluding those invested on a short-term basis (money market investments) during 2007 amounted to approximately \$1.1 billion and were composed mainly of mortgage-backed securities in the amount of \$566 million with a weighted average coupon of 5.76% and government agency securities and U.S. Treasury securities in the amount of \$521 million with a weighted average coupon of 4.46%.

The following table presents the carrying value of investments as of December 31, 2007 and 2006:

|   | <b>2007</b>            | <b>2006</b>  |
|---|------------------------|--------------|
|   | (Dollars in thousands) |              |
| Money market investments                  | \$ 183,136             | \$ 456,470   |
| Investment securities held-to-maturity:   |                        |              |
| U.S. Government and agencies obligations  | 2,365,147              | 2,258,040    |
| Puerto Rico Government obligations        | 31,222                 | 31,716       |
| Mortgage-backed securities                | 878,714                | 1,055,375    |
| Corporate bonds                           | 2,000                  | 2,000        |
|   | 3,277,083              | 3,347,131    |
| Investment securities available-for-sale: |                        |              |
| U.S. Government and agencies obligations  | 16,032                 | 403,592      |
| Puerto Rico Government obligations        | 24,521                 | 25,302       |
| Mortgage-backed securities                | 1,239,169              | 1,253,853    |
| Corporate bonds                           | 4,448                  | 4,961        |
| Equity securities                         | 2,116                  | 12,715       |
|   | 1,286,286              | 1,700,423    |
| Other equity securities                   | 64,908                 | 40,159       |
| Total investments                         | \$ 4,811,413           | \$ 5,544,183 |

**Table of Contents**

Mortgage-backed securities as of December 31, 2007 and 2006, consist of:

|                                    | <b>2007</b>            | <b>2006</b>  |
|------------------------------------|------------------------|--------------|
|                                    | (Dollars in thousands) |              |
| Held-to-maturity:                  |                        |              |
| FHLMC certificates                 | \$ 11,274              | \$ 15,438    |
| FNMA certificates                  | 867,440                | 1,039,937    |
|                                    | 878,714                | 1,055,375    |
| Available-for-sale:                |                        |              |
| FHLMC certificates                 | 158,953                | 7,575        |
| GNMA certificates                  | 44,340                 | 374,368      |
| FNMA certificates                  | 902,198                | 871,540      |
| Mortgage pass-through certificates | 133,678                | 370          |
|                                    | 1,239,169              | 1,253,853    |
| Total mortgage-backed securities   | \$ 2,117,883           | \$ 2,309,228 |

The carrying amounts of investment securities classified as available-for-sale and held-to-maturity as of December 31, 2007 by contractual maturity (excluding mortgage-backed securities and money market investments) are shown below:

|  | <b>Carrying<br/>amount</b> | <b>Weighted average<br/>yield %</b> |
|--|----------------------------|-------------------------------------|
|  | (Dollars in thousands)     |                                     |
| U.S. Government and agencies obligations |                            |                                     |
| Due within one year                      | \$ 254,882                 | 4.14                                |
| Due after five years through ten years   | 7,001                      | 6.05                                |
| Due after ten years                      | 2,119,296                  | 5.82                                |
|  | 2,381,179                  | 5.64                                |
| Puerto Rico Government obligations       |                            |                                     |
| Due after one year through five years    | 13,741                     | 4.99                                |
| Due after five years through ten years   | 24,695                     | 5.80                                |
| Due after ten years                      | 17,307                     | 5.53                                |
|  | 55,743                     | 5.52                                |
| Corporate bonds                          |                            |                                     |
| Due after five years through ten years   | 1,102                      | 7.70                                |
| Due after ten years                      | 5,346                      | 7.16                                |

|   |              |      |
|---|--------------|------|
|   | 6,448        | 7.25 |
| Total   | 2,443,370    |      |
| Mortgage-backed securities  | 2,117,883    |      |
| Equity securities   | 2,116        |      |
| Total investment securities available-for-sale and held-to-maturity | \$ 4,563,369 |      |

Total proceeds from the sale of securities during the year ended December 31, 2007 amounted to \$960.8 million (2006 \$232.5 million).

In 2007, the Corporation realized gross gains of \$5.1 million (2006 \$7.3 million, 2005 \$21.4 million), and realized gross losses of \$1.9 million (2006 \$0.2 million, 2005 \$0.7 million).

During the year ended December 31, 2007, the Corporation recognized through earnings approximately \$5.9 million (2006 \$15.3 million, 2005 \$8.4 million) of losses in the investment securities available-for-sale portfolio that management considered to be other-than-temporarily impaired; 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. The impairment losses were related to equity securities.

**Table of Contents**

Net interest income of future periods may be affected by the acceleration in prepayments of mortgage-backed securities. Acceleration in the prepayments of mortgage-backed securities would lower yields on securities purchased at a premium, as the amortization of premiums paid upon acquisition of these securities would accelerate. Conversely, acceleration in the prepayments of mortgage-backed securities would increase yields on securities purchased at a discount, as the amortization of the discount would accelerate. Also, net interest income in future periods might be affected by the Corporation's investment in callable securities. The recent drop in rates in the long end of the yield curve had the effect of increasing the probability of the exercise of embedded calls in the approximately \$2.1 billion U.S. Agency securities portfolio during 2008. Lower reinvestment rates and a time lag between calls, prepayments and/or the maturity of investments and actual reinvestment of proceeds into new investments, might also affect net interest income. These risks are directly linked to future period's market interest rate fluctuations. Refer to the Risk Management Interest Rate Risk Management section of this Management's Discussion and Analysis for further analysis of the effects of changing interest rates on the Corporation's net interest income and for the interest rate risk management strategies followed by the Corporation.



**Table of Contents****Investment Securities and Loans Receivable Maturities**

The following table presents the maturities or repricing of the loan and investment portfolio as of December 31, 2007:

(Dollars in thousands)

|                                    | One Year<br>or Less | 2-5 Years                  |                               | Over 5 Years               |                               | Total         |
|------------------------------------|---------------------|----------------------------|-------------------------------|----------------------------|-------------------------------|---------------|
|                                    |                     | Fixed<br>Interest<br>Rates | Variable<br>Interest<br>Rates | Fixed<br>Interest<br>Rates | Variable<br>Interest<br>Rates |               |
| Money market investments           | \$ 183,136          | \$                         | \$                            | \$                         | \$                            | \$ 183,136    |
| Mortgage-backed securities         | 247,297             | 476,049                    | 298                           | 1,394,239                  |                               | 2,117,883     |
| Other securities <sup>(1)</sup>    | 321,890             | 13,948                     |                               | 2,174,556                  |                               | 2,510,394     |
| Total investments                  | 752,323             | 489,997                    | 298                           | 3,568,795                  |                               | 4,811,413     |
| Loans <sup>(2)</sup>               |                     |                            |                               |                            |                               |               |
| Residential real estate            | 497,693             | 365,391                    |                               | 2,301,337                  |                               | 3,164,421     |
| Commercial and commercial mortgage | 4,094,929           | 602,295                    | 192,583                       | 192,929                    | 52,238                        | 5,134,974     |
| Construction                       | 1,396,257           | 26,129                     |                               | 32,258                     |                               | 1,454,644     |
| Finance leases                     | 96,621              | 281,935                    |                               |                            |                               | 378,556       |
| Consumer                           | 655,853             | 944,658                    |                               | 13,088                     | 53,552                        | 1,667,151     |
| Total loans                        | 6,741,353           | 2,220,408                  | 192,583                       | 2,539,612                  | 105,790                       | 11,799,746    |
| Total earning assets               | \$ 7,493,676        | \$ 2,710,405               | \$ 192,881                    | \$ 6,108,407               | \$ 105,790                    | \$ 16,611,159 |

(1) Equity securities available-for-sale and other equity securities were included under the one year or less category .

- (2) Non-accruing loans were included under the one year or less category .

**Sources of Funds**

The Corporation's principal funding sources are branch-based deposits, retail brokered CDs, institutional deposits, federal funds purchased, securities sold under agreements to repurchase, notes payable and FHLB advances.

As of December 31, 2007, total liabilities amounted to \$15.8 billion, a decrease of \$395.4 million as compared to \$16.2 billion as of December 31, 2006. The decrease in total liabilities was attributable to less federal funds purchased and securities sold under repurchase agreements consistent with the deleveraging of the investment portfolio and the redemption of the Corporation's \$150 million callable fixed-rate medium-term note during 2007. This was offset by an increase in the amount of advances from the FHLB.

**Table of Contents**

The Corporation maintains unsecured uncommitted lines of credit with other banks. As of December 31, 2007, the Corporation's total unused lines of credit with these banks amounted to \$128.7 million. As of December 31, 2007, the Corporation had an available line of credit with the FHLB, guaranteed with excess collateral pledged to the FHLB in the amount of \$543.7 million.

**Deposits**

Total deposits amounted to \$11.0 billion as of December 31, 2007, \$11.0 billion as of December 31, 2006 and \$12.5 billion as of December 31, 2005.

The following table presents the composition of total deposits:

|  | Weighted<br>average rates<br>as of December<br>31, 2007 | December 31,           |               |               |
|--|---|------------------------|---------------|---------------|
|  |   | 2007                   | 2006          | 2005          |
|  |   | (Dollars in thousands) |               |               |
| Savings accounts   | 1.93%   | \$ 1,036,662           | \$ 984,332    | \$ 1,034,047  |
| Interest-bearing checking accounts   | 2.15%   | 518,570                | 433,278       | 375,305       |
| Certificates of deposit  | 5.09%   | 8,857,405              | 8,795,692     | 10,243,394    |
| Interest-bearing deposits  | 4.63%   | 10,412,637             | 10,213,302    | 11,652,746    |
| Non-interest-bearing deposits  |   | 621,884                | 790,985       | 811,006       |
| Total  |   | \$ 11,034,521          | \$ 11,004,287 | \$ 12,463,752 |
| Interest-bearing deposits:   |   |                        |               |               |
| Average balance outstanding  |   | \$ 10,755,719          | \$ 11,873,608 | \$ 9,855,761  |
| Non-interest-bearing deposits:   |   |                        |               |               |
| Average balance outstanding  |   | \$ 563,990             | \$ 771,343    | \$ 791,815    |
| Weighted average rate during the period<br>on interest-bearing<br>deposits (1) |   | 4.88%                  | 4.63%         | 3.29%         |

(1) Excludes changes in the fair value of callable brokered CDs elected to be measured at fair value under SFAS 159 and changes in the fair value of derivatives that hedge (economically or under fair value hedge accounting)

brokered CDs  
and the basis  
adjustment.

Total deposits are composed of branch-based deposits, brokered CDs and, to a lesser extent, institutional deposits. Institutional deposits include, among others, certificates issued to agencies of the Government of Puerto Rico and to Government agencies in the Virgin Islands.

Total deposits slightly increased as of December 31, 2007, when compared to December 31, 2006, driven by an increase in interest-bearing checking accounts as the Corporation added new products to expand its client base, coupled with a slight increase in brokered CDs. Brokered CDs, which are certificates sold through brokers, amounted to \$7.2 billion as of December 31, 2007 compared to \$7.1 billion as of December 31, 2006. The use of brokered CDs has been particularly important to the growth of the Corporation. The Corporation encounters intense competition in attracting and retaining deposits in Puerto Rico. The brokered CDs market is a very competitive and liquid market in which the Corporation has been able to obtain substantial amounts of funding in short periods of time. This strategy enhanced the Corporation's liquidity position, since the brokered CDs are unsecured and can be obtained at substantially longer maturities than other regular retail deposits. Also, the Corporation has the ability to convert the fixed-rate brokered CDs to short-term adjustable rate liabilities using interest rate swap agreements. For the year ended December 31, 2007, the Corporation issued \$4.3 billion in brokered CDs (including rollover of short-term brokered CDs) compared to \$4.9 billion for the year ended December 31, 2006. Refer to the Risk Management Interest Rate Risk Management section of this Management's Discussion and Analysis for further discussion on interest rate risk management strategies followed by the Corporation.

As of December 31, 2007, 61% of the value of retail brokered CDs held by the Corporation was in the form of long-term fixed callable certificates, in which the Corporation retains the option to cancel the certificates before maturity. As of December 31, 2007, the average remaining maturity on the long-term callable brokered CDs approximated 9.31 years (2006 10.60 years) and on the short-term fixed brokered certificates of deposits

**Table of Contents**

approximated 0.52 years (2006 0.45 years). When using interest rate swaps, the Corporation mainly economically hedges those brokered CDs with long-term maturities.

The following table presents a maturity summary of certificates of deposit with balances of \$100,000 or more, including brokered CDs, as of December 31, 2007. As of December 31, 2007, brokered CDs over 100,000 amounted to \$7.2 billion. Brokered CDs are sold by third-party intermediaries in denominations of \$100,000 or less.

|                                 | (Dollars in thousands) |
|---------------------------------|------------------------|
| Three months or less            | \$ 1,582,362           |
| Over three months to six months | 700,000                |
| Over six months to one year     | 1,038,033              |
| Over one year                   | 4,740,528              |
| Total                           | \$ 8,060,923           |

**Borrowings**

As of December 31, 2007, total borrowings amounted to \$4.5 billion as compared to \$4.7 billion and \$5.8 billion as of December 31, 2006 and 2005, respectively.

The following table presents the composition of total borrowings as of the dates indicated:

|  | Weighted<br>average rates<br>as of December<br>31, 2007 | As of December 31,     |              |              |
|--|---|------------------------|--------------|--------------|
|  |   | 2007                   | 2006         | 2005         |
|  |   | (Dollars in thousands) |              |              |
| Federal funds purchased and securities sold under agreements to repurchase | 4.47%   | \$ 3,094,646           | \$ 3,687,724 | \$ 4,833,882 |
| Advances from FHLB   | 4.73%   | 1,103,000              | 560,000      | 506,000      |
| Notes payable  | 4.76%   | 30,543                 | 182,828      | 178,693      |
| Other borrowings   | 7.57%   | 231,817                | 231,719      | 231,622      |
| Total (1)  | 4.70%   | \$ 4,460,006           | \$ 4,662,271 | \$ 5,750,197 |
| Weighted average rate during the period                                    |   | 5.06%                  | 4.99%        | 4.08%        |

(1) Includes \$2.6 billion as of December 31, 2007 which are tied to variable rates or matured within a year.

The Corporation uses federal funds purchased, repurchase agreements, advances from the Federal Home Loan Bank (FHLB), notes payable and other borrowings, such as trust preferred securities, as additional funding sources.

The Corporation's investment portfolio is substantially funded with repurchase agreements. One of the Corporation's strategies is the use of structured repurchase agreements. Under these agreements, the Corporation attempts to reduce exposure to interest rate risk by lengthening the final maturities of its liabilities while keeping funding cost low. During 2007, the Corporation increased the amount of its structured repos to \$2.3 billion from \$1.4 billion as of

December 31, 2006. Some of the new repos entered in the period were structured as flipper repos which price below LIBOR for an extended period with a floor and a cap and other repos were structured to lock-in, for an extended period, interest rates lower than yields of the securities pledged.

FirstBank is a member of the FHLB system and obtains advances to fund its operations under a collateral agreement with the FHLB that requires the Bank to maintain minimum qualifying mortgages as collateral for advances taken. As of December 31, 2007, the outstanding balance of FHLB advances was \$1.1 billion.

In the past, the Corporation undertook several financing transactions to diversify its funding sources. Among its funding sources are notes payable with an outstanding balance of \$30.5 million as of December 31, 2007. During 2007, the Corporation redeemed a \$150 million medium-term note which carried a cost higher than the overall cost of funding. The derecognition of the unamortized balance of the basis adjustment, placement fees and debt issue

**Table of Contents**

costs resulted in adjustments to earnings of approximately \$1.3 million, increasing the Corporation's net interest income.

In 2004, FBP Statutory Trust I, a statutory trust that is wholly owned by the Corporation and not consolidated in the Corporation's financial statements, sold to institutional investors \$100 million of its variable rate trust preferred securities. The proceeds of the issuance, together with the proceeds of the purchase by the Corporation of \$3.1 million of FBP Statutory Trust I variable rate common securities, were used by FBP Statutory Trust I to purchase \$103.1 million aggregate principal amount of the Corporation's Junior Subordinated Deferrable Debentures.

Also in 2004, FBP Statutory Trust II, a statutory trust that is wholly-owned by the Corporation and not consolidated in the Corporation's financial statements, sold to institutional investors \$125 million of its variable rate trust preferred securities. The proceeds of the issuance, together with the proceeds of the purchase by the Corporation of \$3.9 million of FBP Statutory Trust II variable rate common securities, were used by FBP Statutory Trust II to purchase \$128.9 million aggregate principal amount of the Corporation's Junior Subordinated Deferrable Debentures.

The trust preferred debentures are presented in the Corporation's Consolidated Statement of Financial Condition as Other Borrowings, net of related issuance costs. The variable rate trust preferred securities are fully and unconditionally guaranteed by the Corporation. The \$100 million Junior Subordinated Deferrable Debentures issued by the Corporation in April 2004 and the \$125 million issued in September 2004, mature on September 17, 2034 and September 20, 2034, respectively; however, under certain circumstances, the maturity of Junior Subordinated Debentures may be shortened (which shortening would result in a mandatory redemption of the variable rate trust preferred securities). The trust preferred securities, subject to certain limitations, qualify as Tier I regulatory capital under current Federal Reserve rules and regulations.

**Off-Balance Sheet Arrangements**

In the ordinary course of business, the Corporation engages in financial transactions that are not recorded on the balance sheet, or may be recorded on the balance sheet in amounts that are different than the full contract or notional amount of the transaction. These transactions are designed to (1) meet the financial needs of customers, (2) manage the Corporation's credit, market or liquidity risks, (3) diversify the Corporation's funding sources and (4) optimize capital.

**Table of Contents**

As a provider of financial services, the Corporation routinely enters into commitments with off-balance sheet risk to meet the financial needs of its customers. These commitments may include loan commitments and standby letters of credit. These commitments are subject to the same credit policies and approval process used for on-balance sheet instruments. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial position. As of December 31, 2007, commitments to extend credit and commercial and financial standby letters of credit amounted to approximately \$1.7 billion and \$112.7 million, respectively. Commitments to extend credit are agreements to lend to customers as long as the conditions established in the contract are met. Generally, the Corporation's mortgage banking activities do not enter into interest rate lock agreements with its prospective borrowers.

**Contractual Obligations and Commitments**

The following table presents a detail of the maturities of the Corporation's contractual obligations and commitments, which consist of certificates of deposits, long-term contractual debt obligations, operating leases, other contractual obligations, commitments to sell mortgage loans and commitments to extend credit:

| <b>Contractual Obligations and Commitments</b>                             |                      |                             |                     |                     |                          |
|--|----------------------|-----------------------------|---------------------|---------------------|--------------------------|
| <b>(As of December 31, 2007)</b>   |                      |                             |                     |                     |                          |
| (Dollars in thousands)   |                      |                             |                     |                     |                          |
|  | <b>Total</b>         | <b>Less than 1<br/>year</b> | <b>1-3 years</b>    | <b>3-5 years</b>    | <b>After 5<br/>years</b> |
| Contractual obligations (1):   |                      |                             |                     |                     |                          |
| Certificates of deposit  | \$ 8,857,405         | \$ 3,933,539                | \$ 1,218,259        | \$ 344,840          | \$ 3,360,767             |
| Federal funds purchased and securities sold under agreements to repurchase | 3,094,646            | 807,146                     | 387,500             | 700,000             | 1,200,000                |
| Advances from FHLB   | 1,103,000            | 922,000                     | 97,000              | 74,000              | 10,000                   |
| Notes payable  | 30,543               |                             |                     | 16,237              | 14,306                   |
| Other borrowings   | 231,817              |                             |                     |                     | 231,817                  |
| Operating leases   | 63,184               | 10,168                      | 15,802              | 10,418              | 26,796                   |
| Other contractual obligations  | 17,954               | 4,051                       | 7,808               | 6,095               |                          |
| <b>Total contractual obligations</b>                                       | <b>\$ 13,398,549</b> | <b>\$ 5,676,904</b>         | <b>\$ 1,726,369</b> | <b>\$ 1,151,590</b> | <b>\$ 4,843,686</b>      |
| <br>   |                      |                             |                     |                     |                          |
| Commitments to sell mortgage loans   | \$ 11,801            | \$ 11,801                   |                     |                     |                          |
| <br>   |                      |                             |                     |                     |                          |
| Standby letters of credit  | \$ 112,690           | \$ 112,690                  |                     |                     |                          |
| <br>   |                      |                             |                     |                     |                          |
| Commitments to extend credit:  |                      |                             |                     |                     |                          |
| Lines of credit  | \$ 1,171,411         | \$ 1,171,411                |                     |                     |                          |
| Letters of credit  | 41,478               | 41,478                      |                     |                     |                          |
| Commitments to originate loans   | 455,136              | 455,136                     |                     |                     |                          |
| <br>   |                      |                             |                     |                     |                          |
| <b>Total commercial commitments</b>  | <b>\$ 1,668,025</b>  | <b>\$ 1,668,025</b>         |                     |                     |                          |



- (1) \$30.7 million of tax liability, including accrued interest of \$8.6 million, associated with unrecognized tax benefits under FIN 48 has been excluded due to the high degree of uncertainty regarding the timing of future cash outflows associated with such obligations.

The Corporation has obligations and commitments to make future payments under contracts, such as debt and lease agreements, and under other commitments to sell mortgage loans at fair value and commitments to extend credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Other contractual obligations result mainly from contracts for rental and maintenance of equipment. Since certain commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. In the case of credit cards and personal lines of credit, the Corporation can at any time and without cause cancel the unused credit facility.

**Table of Contents****Capital**

The Corporation's stockholders' equity amounted to \$1.4 billion as of December 31, 2007, compared to \$1.2 billion as of December 31, 2006, an increase of \$192.1 million. The increase in stockholders' equity for 2007 is due to the sale of 9.250 million shares of First BanCorp's common stock to Scotiabank in a private placement. Scotiabank paid a purchase price of \$10.25 per First BanCorp's common share, for a total purchase price of approximately \$94.8 million. The net proceeds to First BanCorp after discounts and expenses were approximately \$91.9 million. Scotiabank acquired 10% of First BanCorp's outstanding common shares as of the close of the transaction. As of December 31, 2007, First BanCorp had 92,504,506 common shares outstanding.

Additional increases in stockholders' equity were mainly composed of after-tax adjustments to beginning retained earnings of approximately \$91.8 million from the adoption of SFAS 159 and net income of \$68.1 million for 2007, partially offset by dividends declared of \$64.9 million during 2007.

As of December 31, 2007, First BanCorp, FirstBank Puerto Rico and FirstBank Florida were in compliance with regulatory capital requirements that were applicable to them as a financial holding company, a state non-member bank and a thrift, respectively (i.e., total capital and Tier 1 capital to risk-weighted assets of at least 8% and 4%, respectively, and Tier 1 capital to average assets of at least 4%). Set forth below are First BanCorp, FirstBank Puerto Rico and FirstBank Florida's regulatory capital ratios as of December 31, 2007 and December 31, 2006, based on existing Federal Reserve, Federal Deposit Insurance Corporation and the Office of Thrift Supervision guidelines.

|   | <b>Banking Subsidiaries</b> |                  |                |  |
|---|-----------------------------|------------------|----------------|--|
|   | <b>First<br/>BanCorp</b>    | <b>FirstBank</b> | <b>Florida</b> | <b>Well-<br/>Capitalized<br/>Minimum</b> |
| <b>As of December 31, 2007</b>                                |                             |                  |                |  |
| Total capital (Total capital to risk-weighted assets)         | 13.86%                      | 13.23%           | 10.92%         | 10.00%                                   |
| Tier 1 capital ratio (Tier 1 capital to risk-weighted assets) | 12.61%                      | 11.98%           | 10.42%         | 6.00%                                    |
| Leverage ratio (1)  | 9.29%                       | 8.85%            | 7.79%          | 5.00%                                    |
| <b>As of December 31, 2006</b>                                |                             |                  |                |  |
| Total capital (Total capital to risk-weighted assets)         | 12.25%                      | 12.25%           | 11.35%         | 10.00%                                   |
| Tier 1 capital ratio (Tier 1 capital to risk-weighted assets) | 11.06%                      | 11.02%           | 10.96%         | 6.00%                                    |
| Leverage ratio (1)  | 7.82%                       | 7.78%            | 7.91%          | 5.00%                                    |

(1) Tier 1 capital to average assets in the case of First BanCorp and FirstBank and Tier 1 Capital to adjusted total assets in the case of FirstBank Florida.

As of December 31, 2007, FirstBank and FirstBank Florida were considered well-capitalized banks for purposes of the prompt corrective action regulations adopted by the FDIC. To be considered a well-capitalized institution under the FDIC's regulations, an institution must maintain a Leverage Ratio of at least 5%, a Tier 1 Capital Ratio of at least 6% and a Total Capital Ratio of at least 10%, and not be subject to any written agreement or directive to meet a specific capital ratio.

**Dividends**

For each of the years ended on December 31, 2007, 2006 and 2005, the Corporation declared in aggregate cash dividends of \$0.28 per common share. Total cash dividends paid on common shares amounted to \$24.6 million for 2007 (or an 88% dividend payout ratio), \$23.3 million for 2006 (or a 53% dividend payout ratio) and \$22.6 million for 2005 (or a 30% dividend payout ratio). Dividends declared on preferred stock amounted to \$40.3 million in 2007, 2006 and 2005.

**Table of Contents****RISK MANAGEMENT****Background**

During the first quarter of 2006, the Board reviewed the Corporation's risk management program with the assistance of outside consultants and counsel. This effort resulted in the realignment of the Corporation's risk management functions and the adoption of an enterprise-wide risk management process. The Board appointed a senior management officer as Chief Risk Officer (CRO) and appointed this officer to the Risk Management Council (RMC) with reporting responsibilities to the CEO and the Audit Committee. In addition, the Board established an Asset/Liability Risk Committee of the Board, with oversight responsibilities for risk management, including asset quality, portfolio performance, interest rate and market sensitivity, and portfolio diversification. In addition, the Asset/Liability Risk Committee has authority to examine the Corporation's assets and liabilities, such as its brokered CDs, to facilitate appropriate oversight by the Board. Finally, management is required to bring to the attention of the Asset/Liability Risk Committee new forms of transactions or variants of forms of transactions that the Asset/Liability Risk Committee has not yet reviewed to enable the Asset/Liability Risk Committee to fully evaluate the consequences of such transactions to the Corporation. In addition, management is required to bring to the attention of the Audit Committee new forms of transactions or variants of forms of transactions for which the Corporation has not determined the appropriate accounting treatment to enable the Audit Committee to fully evaluate the accounting treatment of such transactions.

During 2006 and 2007, management continued to refine and enhance its risk management policies, processes and procedures to maintain effective risk management and governance, including identifying, measuring, monitoring, controlling, mitigating and reporting of all material risks.

**General**

Risks are inherent in virtually all aspects of the Corporation's business activities and operations. Consequently, effective risk management is fundamental to the success of the Corporation. The primary goals of risk management are to ensure that the Corporation's risk taking activities are consistent with the Corporation's objectives and risk tolerance and that there is an appropriate balance between risk and reward in order to maximize shareholder value.

The Corporation has in place a risk management framework to monitor, evaluate and manage the principal risks assumed in conducting its activities. First BanCorp's business is subject to eight broad categories of risks: (1) interest rate risk, (2) market risk, (3) credit risk, (4) liquidity risk, (5) operational risk, (6) legal and compliance risk, (7) reputation risk, and (8) contingency risk.

**Risk Definition****Interest Rate Risk**

Interest rate risk is the risk to earnings or capital arising from adverse movements in interest rates.

**Market Risk**

Market risk is the risk to earnings or capital arising from adverse movements in market rates or prices, such as interest rates or equity prices. The Corporation evaluates market risk together with interest rate risk, refer to Interest Rate Risk Management section below for further details.

**Credit Risk**

Credit risk is the risk to earnings or capital arising from a borrower's or a counterparty's failure to meet the terms of a contract with the Corporation or otherwise to perform as agreed. Refer to Credit Risk Management section below for further details.

**Table of Contents**

**Liquidity Risk**

Liquidity risk is the risk to earnings or capital arising from the possibility that the Corporation will not have sufficient cash to meet the short term liquidity demands such as from deposit redemptions or loan commitments. Refer to Liquidity Risk Management section below for further details.

**Operational Risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This risk is inherent across all functions, products and services of the Corporation.

**Legal and Compliance Risk**

Legal and compliance risk is the risk of negative impact to business activities, earnings or capital, regulatory relationships or reputation as a result of failure to adhere to or comply with regulations, laws, industry codes or rules, regulatory expectations or ethical standards.

**Reputational Risk**

Reputational risk is the risk to earnings and capital arising from any adverse impact on the Corporation's market value, capital or earnings of negative public opinion, whether true or not. This risk affects the Corporation's ability to establish new relationships or services, or to continue servicing existing relationships.

**Contingency Risk**

Contingency risk is the risk to earnings and capital associated with the Corporation's preparedness for the occurrence of an unforeseen event.

**Risk Governance**

The following discussion highlights the roles and responsibilities of the key participants in the Corporation's risk management framework:

**Board of Directors**

The Board of Directors provides oversight and establishes the objectives and limits of the Corporation's risk management activities. The Asset/Liability Risk Committee and the Audit Committee assist the Board of Directors in executing this responsibility.

**Asset/Liability Risk Committee**

The Asset/Liability Risk Committee of the Corporation is appointed by the Board of Directors to assist the Board of Directors in its oversight of risk management, including asset quality, portfolio performance, interest rate and market sensitivity, and portfolio diversification. In addition, the Asset/Liability Risk Committee has the authority to examine the Corporation's assets and liabilities. In so doing, the Committee's primary general functions involve:

The establishment of a process to enable the recognition, assessment, and management of risks that could affect the Corporation's assets and liabilities;

The identification of the Corporation's risk tolerance levels relating to its assets and liabilities;

The evaluation of the adequacy and effectiveness of the Corporation's risk management process relating to the Corporation's assets and liabilities, including management's role in that process;

## **Table of Contents**

The evaluation of the Corporation's compliance with its risk management process relating to the Corporation's assets and liabilities; and

The approval of loans and other business matters following the lending authorities approved by the Board.

### **Audit Committee**

The Audit Committee of First BanCorp is appointed by the Board of Directors to assist the Board of Directors in its oversight of risk management processes related to compliance, operations, the Corporation's internal audit function, and the Corporation's external financial reporting and internal control over financial reporting process. In performing this function, the Audit Committee is assisted by the CRO, the RMC, and other members of senior management.

### **Risk Management Council**

The RMC is responsible for supporting the CRO in measuring and managing the Corporation's aggregate risk profile. The RMC executes management's oversight role regarding risk management. This committee is designed to ensure that the appropriate authorities, resources, responsibilities and reporting are in place to support an effective risk management program. The RMC Council consists of various senior executives throughout the Corporation and meets on a monthly basis. The RMC is responsible for ensuring that the Corporation's overall risk profile is consistent with the Corporation's objectives and risk tolerance levels. The RMC is also responsible for ensuring that there are appropriate and effective risk management processes to identify, measure and manage risks on an aggregate basis. Refer to Interest Rate Risk, Credit Risk, Liquidity, Operational, Legal and Regulatory Risk Management - Operational Risk discussion below for further details of matters discussed in the RMC.

### **Other Management Committees**

As part of its governance framework, the Corporation has various risk management related-committees. These committees are jointly responsible for ensuring adequate risk measurement and management in their respective areas of authority. At the management level, these committees include:

- (1) Management's Investment and Asset Liability Committee oversees interest rate and market risk, liquidity management and other related matters. Refer to Interest Rate Risk Management discussion below for further details.
- (2) Information Technology Steering Committee is responsible for the oversight of and counsel on matters related to information technology including the development of information management policies and procedures throughout the Corporation.
- (3) Bank Secrecy Act Committee is responsible for oversight, monitoring and reporting of the Corporation's compliance with Bank Secrecy Act.
- (4) Credit Committees (Delinquency and Credit Management Committee) oversee and establish standards for credit risk management processes within the Corporation. The Credit Management Committee is responsible for the approval of loans above an established size threshold. The Delinquency Committee is responsible for the periodic reviews of (1) past due loans, (2) overdrafts, (3) non-accrual loans, (4) OREO assets, and (5) the bank's watch list and non-performing loans.

### **Executive Officers**

As part of its governance framework, the following officers play a key role in the Corporation's risk management process:

- (1) Chief Executive Officer and Chief Operating Officer responsible for the overall risk governance structure.
- (2) Chief Risk Officer responsible for the oversight of the risk management organization as well as risk governance processes. In addition, the CRO manages the operational risk program.

**Table of Contents**

- (3) Chief Credit Officer manages the Corporation's credit risk program.
- (4) Chief Financial Officer in combination with the Corporation's Treasurer, manages the Corporation's interest rate and market and liquidity risks programs and in combination with the Corporation's Chief Accounting Officer is responsible for the implementation of accounting policies and practices in accordance with generally accepted accounting principles in the United States and applicable regulatory requirements.
- (5) Chief Accounting Officer responsible for the development and implementation of the Corporation's accounting policies and practices and the review and monitoring of critical accounts and transactions to ensure that they are managed in accordance with generally accepted accounting principles in the United States and applicable regulatory requirements.

**Other Officers**

In addition to the centralized Enterprise Risk Management function, certain lines of business and corporate functions have their own Risk Managers and support staff. The Risk Managers, while reporting directly within their respective line of business or function, facilitate communications with the Corporation's risk functions and works in partnership with the CRO to ensure alignment with sound risk management practices and expedite the implementation of the enterprise risk management framework and policies.

**Interest Rate Risk, Credit Risk, Liquidity, Operational, Legal and Regulatory Risk Management**

The following discussion highlights First BanCorp's adopted policies and procedures for interest rate risk, credit risk, liquidity risk, operational risk, legal and regulatory risk.

**Interest Rate Risk Management**

First BanCorp manages its asset/liability position in order to limit the effects of changes in interest rates on net interest income. The Management's Investment and Asset Liability Committee of the Corporation ( MIALCO ) oversees interest rate risk, liquidity management and other related matters. The MIALCO, which reports to the Investment Sub-committee of the Board of Directors' Asset/Liability Risk Committee, is composed of senior management officers, including the Chief Executive Officer, the Chief Financial Officer, the Chief Operating Officer, the Chief Risk Officer, the Whole-Sale Banking Executive, the Risk Manager of the Treasury and Investment Department, the Financial Risk Manager and the Treasurer.

Committee meetings focus on, among other things, current and expected conditions in world financial markets, competition and prevailing rates in the local deposit market, liquidity, unrealized gains and losses in securities, recent or proposed changes to the investment portfolio, alternative funding sources and their costs, hedging and the possible purchase of derivatives such as swaps and caps, and any tax or regulatory issues which may be pertinent to these areas. The MIALCO approves funding decisions in light of the Corporation's overall growth strategies and objectives. On a quarterly basis, the MIALCO performs a comprehensive asset/liability review, examining interest rate risk as described below together with other issues such as liquidity and capital.

The Corporation performs on a quarterly basis a net interest income simulation analysis on a consolidated basis to estimate the potential change in future earnings from projected changes in interest rates. These simulations are carried out over a one-year and a five-year time horizon, assuming gradual upward and downward interest rate movements of 200 basis points, achieved during a twelve-month period. Simulations are carried out in two ways:

- (1) using a static balance sheet as the Corporation had on the simulation date, and
- (2) using a growing balance sheet based on recent growth patterns and strategies.

The balance sheet is divided into groups of assets and liabilities detailed by maturity or re-pricing and their corresponding interest yields and costs. As interest rates rise or fall, these simulations incorporate expected future lending rates, current and expected future funding sources and cost, the possible exercise of options, changes in

**Table of Contents**

prepayment rates, deposits decay and other factors which may be important in projecting the future growth of net interest income.

The Corporation uses asset-liability management software to project future movements in the Corporation's balance sheet and income statement. The starting point of the projections generally corresponds to the actual values of the balance sheet on the date of the simulations. For the December 31, 2007 simulation and based on the significant downward shift in rates experienced at the beginning of 2008, the Corporation's MIALCO decided to update the rates as of the end of January 2008 and use these as the starting point for the projections.

These simulations are highly complex, and use many simplifying assumptions that are intended to reflect the general behavior of the Corporation over the period in question. There can be no assurance that actual events will match these assumptions in all cases. For this reason, the results of these simulations are only approximations of the true sensitivity of net interest income to changes in market interest rates. During 2007, the Corporation began a process of refining and enhancing interest rate risk measurement and analysis. The Corporation is in the process of implementing a more sophisticated software to measure the Corporation's interest rate risk profile.

The following table presents the results of the simulations as of December 31, 2007 and 2006. Consistent with prior years, these exclude non-cash changes in the fair value of derivatives and SFAS 159 liabilities:

|                       | December 31, 2007                             |          |                       |          | December 31, 2006                             |          |                       |          |
|-----------------------|---|----------|-----------------------|----------|---|----------|-----------------------|----------|
|                       | Net Interest Income Risk (projected for 2008) |          |                       |          | Net Interest Income Risk (projected for 2007) |          |                       |          |
|                       | Static Simulation                             |          | Growing Balance Sheet |          | Static Simulation                             |          | Growing Balance Sheet |          |
|                       | \$ Change                                     | % Change | \$ Change             | % Change | \$ Change                                     | % Change | \$ Change             | % Change |
| (Dollars in millions) |   |          |                       |          |   |          |                       |          |
| +200 bps ramp         | (\$ 8.1)                                      | (1.64%)  | (\$ 8.4)              | (1.66%)  | (\$34.6)                                      | (6.86%)  | (\$36.9)              | (7.1%)   |
| -200 bps ramp         | (\$13.2)                                      | (2.68%)  | (\$13.2)              | (2.60%)  | 50.7  | 10.1%    | 20.4                  | 3.9%     |

Future net interest income could be affected by the Corporation's investments in callable securities. The recent drop in the long end of the yield curve has the effect of increasing the probability of the exercise of embedded calls in the approximately \$2.1 billion U.S. Agency securities portfolio during 2008.

The decrease in net interest income risk from 2006 to 2007, on growing balance sheet scenario, primarily relates to the change in the mix of floating and fixed rate assets and liabilities. As part of the strategy to limit the interest rate risk and reduce the re-pricing gaps of the Corporation's assets and liabilities, the maturity and the repricing frequency of the liabilities has been extended to longer terms. Also, the concentration of long-term fixed rate securities has been reduced.

*Derivatives.* First BanCorp uses derivative instruments and other strategies to manage its exposure to interest rate risk caused by changes in interest rates beyond management's control.

The following summarizes major strategies, including derivative activities, used by the Corporation in managing interest rate risk:

**Interest rate swaps** Interest rate swap agreements generally involve the exchange of fixed and floating-rate interest payment obligations without the exchange of the underlying principal. Since a substantial portion of the Corporation's loans, mainly commercial loans, yield variable rates, the interest rate swaps are utilized to convert fixed-rate brokered certificates of deposit (liabilities), mainly those with long-term maturities, to a variable rate to better match the variable rate nature of these loans.

**Interest rate cap agreements** Interest rate cap agreements provide the right to receive cash if a reference interest rate rises above a contractual rate. The value increases as the reference interest rate rises. The Corporation enters into interest rate cap agreements to protect against rising interest rates. Specifically, the interest rate of the Corporation's commercial loans to other financial institutions is generally a variable rate limited to the weighted-average coupon of the referenced residential mortgage collateral, less a contractual servicing fee. The Corporation utilizes interest rate cap agreements to protect against rising interest rates.





**Table of Contents**

**Structured repurchase agreements** The Corporation uses structured repurchase agreements, with embedded call options, to reduce the Corporation's exposure to interest rate risk by lengthening the contractual maturities of its liabilities, while keeping funding costs low. Another type of structured repurchase agreement includes repurchased agreements with embedded cap corridors; these instruments also provide protection for a rising rate scenario.

**Table of Contents**

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

|  | <b>Notional Amount<br/>As of December 31,</b> |                     |
|--|---|---------------------|
|  | <b>2007</b>                                   | <b>2006</b>         |
|  | (Dollars in thousands)                        |                     |
| Interest rate swap agreements:         |   |                     |
| Pay fixed versus receive floating      | \$ 80,212                                     | \$ 80,720           |
| Receive fixed versus pay floating      | 4,164,261                                     | 4,802,370           |
| Embedded written options               | 53,515  | 13,515              |
| Purchased options                      | 53,515  | 13,515              |
| Written interest rate cap agreements   | 128,075                                       | 125,200             |
| Purchased interest rate cap agreements | 294,982                                       | 330,607             |
|  | <b>\$ 4,774,560</b>                           | <b>\$ 5,365,927</b> |

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

|   | <b>Notional Amount<br/>December 31,</b> |                     |
|---|---|---------------------|
|   | <b>2007</b>                             | <b>2006</b>         |
|   | (Dollars in thousands)                  |                     |
| Economic undesignated hedges:   |   |                     |
| Interest rate swaps used to hedge fixed rate certificates of deposit, notes payable and loans | \$ 4,244,473                            | \$ 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  | 128,075                                 | 125,200             |
| Purchased interest rate cap agreements  | 294,982                                 | 330,607             |
| Total derivatives not designated as hedge   | 4,774,560                               | 819,310             |
| Designated hedges:  |   |                     |
| Fair value hedge:   |   |                     |
| 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   | <b>\$ 4,774,560</b>                     | <b>\$ 5,365,927</b> |

**Table of Contents**

The majority of the Corporation's derivatives represent interest rate swaps used mainly to convert long-term fixed-rate brokered CDs to a variable rate. A summary of these interest rate swaps as of December 31, 2007 and 2006 follows:

|  | <b>As of December 31,</b> |             |
|--|---------------------------|-------------|
|  | <b>2007</b>               | <b>2006</b> |
|  | (Dollars in thousands)    |             |
| Pay fixed/receive floating (generally used to economically hedge variable rate loans):                       |                           |             |
| Notional amount  | \$ 80,212                 | \$ 80,720   |
| Weighted average receive rate at year end  | 7.09%                     | 7.38%       |
| Weighted average pay rate at year end  | 6.75%                     | 6.37%       |
| Floating rates range from 167 to 252 basis points over LIBOR rate  |                           |             |
| Receive fixed/pay floating (generally used to economically hedge fixed-rate brokered CDs and notes payable): |                           |             |
| Notional amount  | \$4,164,261               | \$4,802,370 |
| Weighted average receive rate at year end  | 5.26%                     | 5.16%       |
| Weighted average pay rate at year end  | 5.07%                     | 5.42%       |
| Floating rates range from minus 5 basis points to 11 basis points over 3-month LIBOR rate                    |                           |             |

The changes in notional amount of interest rate swaps outstanding during the years ended December 31, 2007 and 2006 follows:

|                                       | <b>Notional amount</b> |                  |
|---------------------------------------|------------------------|------------------|
|                                       | (Dollars in thousands) |                  |
| Pay-fixed and receive-floating swaps: |                        |                  |
| <b>Balance at December 31, 2005</b>   | <b>\$</b>              | <b>109,320</b>   |
| Canceled and matured contracts        |                        | (28,600)         |
| New contracts                         |                        |                  |
| <b>Balance at December 31, 2006</b>   |                        | <b>80,720</b>    |
| Canceled and matured contracts        |                        | (508)            |
| New contracts                         |                        |                  |
| <b>Balance at December 31, 2007</b>   | <b>\$</b>              | <b>80,212</b>    |
| Receive-fixed and pay floating swaps: |                        |                  |
| <b>Balance at December 31, 2005</b>   | <b>\$</b>              | <b>5,751,128</b> |
| Canceled and matured contracts        |                        | (948,758)        |
| New contracts                         |                        |                  |
| <b>Balance at December 31, 2006</b>   |                        | <b>4,802,370</b> |
| Canceled and matured contracts        |                        | (638,109)        |
| New contracts                         |                        |                  |
| <b>Balance at December 31, 2007</b>   | <b>\$</b>              | <b>4,164,261</b> |

As of December 31, 2007, derivatives not designated or not qualifying for hedge accounting with a positive fair value of \$14.7 million (December 31, 2006 \$15.0 million) and a negative fair value of \$67.2 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.

Derivative instruments, such as interest rate swaps, are subject to market risk. The Corporation's derivatives are mainly composed of interest rate swaps that are used to convert the fixed interest payment on its brokered certificates of deposit and medium-term notes to variable payments (receive fixed/pay floating). As is the case with investment securities, the market value of derivative instruments is largely a function of the financial market's expectations regarding the future direction of interest rates. Accordingly, current market values are not necessarily

**Table of Contents**

indicative of the future impact of derivative instruments on earnings. This will depend, for the most part, on the shape of the yield curve as well as the level of interest rates. In addition, effective January 1, 2007 the Corporation adopted SFAS 159 for a substantial portion of its brokered certificates of deposit portfolio and certain medium-term notes for which changes in fair value are also recorded in current period earnings.

The following tables summarize the fair value changes of the Corporation's derivatives as well as the source of the fair values:

**Fair Value Change**

|  | <b>Year Ended<br/>December 31,<br/>2007</b> |
|--|---|
| (Dollars in thousands)   |   |
| Fair value of contracts outstanding at the beginning of the year | \$ (127,978)                                |
| Contracts realized or otherwise settled during the year          | 15,062                                      |
| Changes in fair value during the year                            | 60,466                                      |
| Fair value of contracts outstanding at the end of the year       | \$ (52,450)                                 |

**Source of Fair Value**

| (Dollars in thousands)              | Payments Due by Period                  |                          |                          |                                     |                     |
|-------------------------------------|---|--------------------------|--------------------------|-------------------------------------|---------------------|
|                                     | Maturity<br>Less<br>Than<br>One<br>Year | Maturity<br>1-3<br>Years | Maturity<br>3-5<br>Years | Maturity<br>In Excess<br>of 5 Years | Total<br>Fair Value |
| <b>As of December 31, 2007</b>      |   |                          |                          |                                     |                     |
| Prices provided by external sources | \$ (122)                                | \$ (743)                 | \$ (680)                 | \$ (52,450)                         | \$ (52,450)         |

Prior to April 2006, none of the derivative instruments held by the Corporation qualified for hedge accounting. Effective April 3, 2006, the Corporation adopted the long-haul method of effectiveness testing under SFAS 133 for substantially all of the interest rate swaps that hedge its callable brokered CDs and medium-term notes. The long-haul method requires periodic assessment of hedge effectiveness and measurement of ineffectiveness. The ineffectiveness results to the extent the changes in the fair value of the derivative do not offset the changes in fair value of the hedged liability. Prior to the implementation of fair value hedge accounting, the Corporation recorded, as part of interest expense, unrealized losses in the valuation of interest rate swaps of approximately \$69.7 million during the first quarter of 2006.

Effective January 1, 2007, the Corporation decided to early adopt SFAS 159 for its callable brokered CDs and certain fixed medium-term notes ( Notes ) that were hedged with interest rate swaps. One of the main considerations 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, First BanCorp selected the fair value measurement for approximately \$4.4 billion, or 63%, of the brokered CDs portfolio and for approximately \$15.4 million, or 9%, of the Notes. The CDs and Notes chosen for the fair value measurement option were hedged at January 1, 2007 by callable interest rate swaps with the same terms and conditions. The adoption of SFAS 159 resulted in a positive after-tax impact to retained earnings of approximately \$91.8 million. Under SFAS 159, this one-time credit was recognized as an adjustment to beginning retained earnings.

As a result of the implementation of SFAS 159 and the discontinuance of hedge accounting, all of the derivative instruments held by the Corporation as of December 31, 2007 were considered economic undesignated hedges.

The decrease in the notional amount of derivative instruments during 2007 is partially due to: (1) the termination of certain interest rate swaps that were no longer economically hedging brokered CDs as the notional balances exceeded

those of the brokered CDs, and (2) the termination of an interest rate swap that economically hedged the \$150 million medium-term note redeemed during the second quarter of 2007. The notional amount of the interest rate swaps previously held to economically hedge brokered CDs that were cancelled during 2007 amounted to \$142.2 million with a weighted-average pay-rate of 5.38% and a weighted-average receive-rate of 5.22%. The interest rate swap previously held to economically hedge the \$150 million medium-term note had a notional amount of \$150.0 million with a pay-rate of 6.00% and a receive-rate of 5.54% at the time of cancellation.

**Table of Contents**

The use of derivatives involves market and credit risk. The market risk of derivatives stems principally from the potential for changes in the value of derivative contracts based on changes in interest rates. The credit risk of derivatives arises from the potential of default from the counterparty. To manage this credit risk, the Corporation deals with counterparties of good credit standing, enters into master netting agreements whenever possible and, when appropriate, obtains collateral. Master netting agreements incorporate rights of set-off that provide for the net settlement of contracts with the same counterparty in the event of default.

**Derivative Counterparty Credit Exposure**

(Dollars in thousands)

(Dollars in thousands)

| Rating (1)                 | Number<br>of<br>Counterparties<br>(2) Notional |              | December 31, 2007                |                            |                        |
|----------------------------|--|--------------|----------------------------------|----------------------------|------------------------|
|                            |  |              | Total                            |                            |                        |
|                            |  |              | Exposure at<br>Fair Value<br>(3) | Negative<br>Fair<br>Values | Total<br>Fair<br>Value |
| AA                         | 1  | \$ 90,016    | \$                               | \$ (929)                   | \$ (929)               |
| AA-                        | 5  | 2,411,575    | 7,057                            | (32,161)                   | (25,104)               |
| A+                         | 5  | 2,010,491    | 5,079                            | (24,091)                   | (19,012)               |
| A                          | 1  | 74,400       | 2,305                            | (875)                      | 1,430                  |
| CCC                        | 1  | 3,768        | 72                               |                            | 72                     |
| Subtotal                   | 13   | \$ 4,590,250 | \$ 14,513                        | \$ (58,056)                | \$ (43,543)            |
| Other derivatives:         |  |              |                                  |                            |                        |
| Caps (4)                   |  | 128,075      |                                  | (47)                       | (47)                   |
| Equity-indexed options (4) |  | 53,515       |                                  | (9,048)                    | (9,048)                |
| Loans (4)                  |  | 2,720        | 188                              |                            | 188                    |
|                            |  | \$ 4,774,560 | \$ 14,701                        | \$ (67,151)                | \$ (52,450)            |

(Dollars in thousands)

| Rating (1)                 | Number<br>of<br>Counterparties<br>(2) Notional |              | December 31, 2006                |                            |                     |
|----------------------------|--|--------------|----------------------------------|----------------------------|---------------------|
|                            |  |              | Total                            |                            |                     |
|                            |  |              | Exposure at<br>Fair Value<br>(3) | Negative<br>Fair<br>Values | Total<br>Fair Value |
| AA+                        | 1  | \$ 240,772   | \$                               | \$ (6,553)                 | \$ (6,553)          |
| AA-                        | 7  | 3,088,244    | 3,082                            | (87,046)                   | (83,964)            |
| A+                         | 4  | 1,690,069    | 2,843                            | (44,637)                   | (41,794)            |
| BBB-                       | 1  | 205,407      | 9,088                            |                            | 9,088               |
| Subtotal                   | 13   | \$ 5,224,492 | \$ 15,013                        | \$ (138,236)               | \$ (123,223)        |
| Other derivatives:         |  |              |                                  |                            |                     |
| Caps (4)                   |  | 125,200      |                                  | (390)                      | (390)               |
| Equity-indexed options (4) |  | 13,515       |                                  | (4,347)                    | (4,347)             |
| Loans (4)                  |  | 2,720        |                                  | (18)                       | (18)                |



|              |    |        |              |              |
|--------------|----|--------|--------------|--------------|
| \$ 5,365,927 | \$ | 15,013 | \$ (142,991) | \$ (127,978) |
|--------------|----|--------|--------------|--------------|

- (1) Based on the S&P and Fitch Long Term Issuer Credit Ratings
- (2) Based on legal entities. Affiliated legal entities are reported separately.
- (3) For each counterparty, this amount includes derivatives with a positive fair value excluding the related accrued interest receivable/payable.
- (4) These derivatives represent transactions sold to local companies or institutions for which a credit rating is not readily available. The credit exposure is mitigated because a transactions with the same terms and conditions was bought with a rated counterparty.

### **Credit Risk Management**

First BanCorp is subject to credit risk mainly with respect to its portfolio of loans receivable and off-balance sheet instruments, mainly derivatives and loan commitments. Loans receivable represents loans that First BanCorp holds for investment and, therefore, First Bancorp is at risk for the term of the loan. Loan commitments represent commitments to extend credit, subject to specific condition, for specific amounts and maturities. These commitments may expose the Corporation to credit risk and are subject to the same review and approval process as for loans. Refer to Contractual Obligations and Commitments above for further details. The credit risk of

**Table of Contents**

derivatives arises from the potential of counterparty's default on its contractual obligations. To manage this credit risk, the Corporation deals with counterparties of good credit standing, enters into master netting agreements whenever possible and, when appropriate, obtains collateral. For further details and information on the Corporation's derivative credit risk exposure, refer to Interest Rate Risk Management section above. The Corporation manages its credit risk through credit policy, underwriting, quality control and an established delinquency committee. The Corporation also employs proactive collection and loss mitigation efforts.

The Corporation may also encounter risk of default in relation to its securities portfolio. The securities held by the Corporation are principally mortgage-backed securities and U.S. Treasury and agency securities. Thus, a substantial portion of these instruments are guaranteed by mortgages, a U.S. government-sponsored entity or the full faith and credit of the U.S. government and are deemed to be of the highest credit quality.

Management's Credit Committee, comprised of the Corporation's Chief Credit Risk Officer and other senior executives, has primary responsibility for setting strategies to achieve the Corporation's credit risk goals and objectives. Those goals and objectives are documented in the Corporation's Credit Policy.

*Allowance for Loan and Lease Losses and Non-performing Assets*

*Allowance for Loan and Lease Losses*

The provision for loan and lease losses is charged to earnings to maintain the allowance for loan and lease losses at a level that the Corporation considers adequate to absorb probable losses inherent in the portfolio. The Corporation establishes the allowance for loan and lease losses based on its asset classification report to cover the total amount of any assets classified as a loss, the probable loss exposure of other classified assets, and the estimated probable losses of assets not classified. The adequacy of the allowance for loan and lease losses is also based upon a number of additional factors including historical loan and lease loss experience, current economic conditions, the fair value of the underlying collateral, and the financial condition of the borrowers, and, as such, includes amounts based on judgments and estimates made by the Corporation. Although management believes that the allowance for loan and lease losses is adequate, factors beyond the Corporation's control, including factors affecting the economies of Puerto Rico, the United States (principally the state of Florida), the U.S.VI or British VI may contribute to delinquencies and defaults, thus necessitating additional reserves.

**Table of Contents**

For small, homogeneous loans, including residential mortgage loans, auto loans, consumer loans, finance lease loans, and commercial and construction loans in amounts under \$1.0 million, the Corporation evaluates a specific allowance based on average historical loss experience for each corresponding type of loans and market conditions. The methodology of accounting for all probable losses is made in accordance with the guidance provided by SFAS 5, Accounting for Contingencies.

Commercial and construction loans in amounts over \$1.0 million are individually evaluated on a quarterly basis for impairment in accordance with the provisions of SFAS 114, Accounting by Creditors for Impairment of a Loan. A loan is impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. The impairment loss, if any, on each individual loan identified as impaired is generally measured based on the present value of expected cash flows discounted at the loan's effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price, or the fair value of the collateral, if the loan is collateral dependent. If foreclosure is probable, the creditor is required to measure the impairment based on the fair value of the collateral. The fair value of the collateral is generally obtained from appraisals. Updated appraisals are obtained when the Corporation determines that loans are impaired, as it did recently with respect to loan relationships in the Miami Agency and in Puerto Rico, which are discussed below, and for certain loans on a spot basis selected by specific characteristics such as delinquency levels and loan-to-value ratios. Should the appraisal show a deficiency, the Corporation records an allowance for loan losses related to these loans.

As a general procedure, the Corporation internally reviews appraisals on a spot basis as part of the underwriting and approval process. For construction loans in the Miami Agency, appraisals are reviewed by an outsourced contracted appraiser. Once a loan backed by real estate collateral deteriorates or is accounted for in non-accrual status, a full assessment of the value of the collateral is performed. If the Corporation commences litigation to collect an outstanding loan or commences foreclosure proceedings against a borrower (which includes the collateral), a new appraisal report is requested and the book value is adjusted accordingly, either by a corresponding reserve or a charge-off.

In 2006, the Corporation hired an independent consulting firm to perform an assessment of the residential real estate loan portfolio in Puerto Rico. This review included, among other things, the purchase of realtors' data to confirm recent property values and purchase of appraisers' databases for the same reason. The independent assessment determined that, based on the deterioration of the economic conditions in Puerto Rico and the increase in the home price index in Puerto Rico, the Corporation needed to increase its allowance for loan and lease losses.

The Corporation continues to update the analysis on a yearly basis, the latest being in March 2007 when the Corporation obtained similar results. Historically, the residential real estate portfolio losses have not been significant. More than 90% of the residential loan portfolio is fixed rate, thus there is no re-pricing risk.

The Credit Risk area requests new collateral appraisals for impaired collateral dependent loans. In order to determine present market conditions in Puerto Rico and the Virgin Islands, and to gauge property appreciation rates, opinions of value are requested for a sample of delinquent residential real estate loans. The valuation information gathered through these appraisals is considered in the Corporation's allowance model assumptions.

Substantially all of the Corporation's loan portfolio is located within the boundaries of the U.S. economy. Whether the collateral is located in Puerto Rico, the U.S. Virgin Islands or the U.S. mainland, the performance of the Corporation's loan portfolio and the value of the collateral backing the transactions are dependent upon the performance of and conditions within each specific area real estate market. Recent economic reports related to the real estate market in Puerto Rico indicate that certain pockets of the real estate market are subject to readjustments in value driven not by demand but more by the purchasing power of the consumers and general economic conditions. However, the outlook is for a stable real estate market with values not growing in certain areas due to the self-inflicted wounds associated with the governmental and political environment in Puerto Rico. The Corporation is protected by healthy loan to value ratios set upon original approval and driven by the Corporation's regulatory and credit policy standards. The real estate market for the U.S. Virgin Islands remains fairly strong.

**Table of Contents**

The following table sets forth an analysis of the activity in the allowance for loan and lease losses during the periods indicated:

| Year ended December 31,  | 2007                   | 2006       | 2005       | 2004       | 2003       |
|--|------------------------|------------|------------|------------|------------|
|  | (Dollars in thousands) |            |            |            |            |
| Allowance for loan and lease losses, beginning of year                 | \$ 158,296             | \$ 147,999 | \$ 141,036 | \$ 126,378 | \$ 111,911 |
| Provision for loan and lease losses                                    | 120,610                | 74,991     | 50,644     | 52,799     | 55,916     |
| Loans charged-off:   |                        |            |            |            |            |
| Residential real estate  | (985)                  | (997)      | (945)      | (254)      | (475)      |
| Commercial and Construction  | (15,170)               | (6,036)    | (8,558)    | (6,190)    | (6,488)    |
| Finance leases   | (10,393)               | (5,721)    | (2,748)    | (2,894)    | (2,424)    |
| Consumer   | (68,282)               | (64,455)   | (39,669)   | (34,704)   | (38,745)   |
| Recoveries   | 6,092                  | 12,515     | 6,876      | 5,901      | 6,683      |
| Net charge-offs  | (88,738)               | (64,694)   | (45,044)   | (38,141)   | (41,449)   |
| Other adjustments <sup>(1)</sup>                                       |                        |            | 1,363      |            |            |
| Allowance for loan and lease losses, end of year                       | \$ 190,168             | \$ 158,296 | \$ 147,999 | \$ 141,036 | \$ 126,378 |
| Allowance for loan and lease losses to year end total loans receivable | 1.61%                  | 1.41%      | 1.17%      | 1.46%      | 1.80%      |
| Net charge-offs to average loans outstanding during the year           | 0.79%                  | 0.55%      | 0.39%      | 0.48%      | 0.66%      |
| Provision for loan and lease losses to net charge-offs during the year | 1.36x                  | 1.16x      | 1.12x      | 1.38x      | 1.35x      |

(1) Represents allowance for loan losses from the acquisition of First Bank Florida.

**Table of Contents**

The following table sets forth information concerning the allocation of the Corporation's allowance for loan losses by loan category and the percentage of loans in each category to total loans as of the dates indicated:

**Allocation of Allowance for Loan and Lease Losses**

| As of December 31,   | 2007     |         | 2006     |         | 2005     |         | 2004     |         | 2003     |         |
|--|----------|---------|----------|---------|----------|---------|----------|---------|----------|---------|
|  | Amount   | Percent | Amount   | Percent | Amount   | Percent | Amount   | Percent | Amount   | Percent |
| Residential real estate loans                                      | \$ 8,240 | 27%     | \$ 6,488 | 25%     | \$ 3,409 | 18%     | \$ 1,595 | 14%     | \$ 4,298 | 15%     |
| Commercial mortgage loans  | 13,699   | 11%     | 13,706   | 11%     | 9,827    | 9%      | 8,958    | 7%      | 11,746   | 10%     |
| Construction loans   | 38,108   | 12%     | 18,438   | 13%     | 12,623   | 9%      | 5,077    | 4%      | 3,710    | 5%      |
| Commercial loans (including loans to local financial institutions) | 63,030   | 33%     | 53,929   | 32%     | 58,117   | 48%     | 70,906   | 59%     | 58,084   | 52%     |
| Finance leases   | 6,445    | 3%      | 6,194    | 3%      | 4,684    | 2%      | 4,043    | 2%      | 4,310    | 2%      |