FIRST BANCORP /PR/
Form 10-Q
August 20, 2007

# UNITED STATES <br> SECURITIES AND EXCHANGE COMMISSION <br> Washington, DC 20549 

FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2006

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

For the transition period from $\qquad$ to $\qquad$
COMMISSION FILE NUMBER 0-17224
FIRST BANCORP.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

Puerto Rico
(State or other jurisdiction of incorporation or organization)

1519 Ponce de León Avenue, Stop 23
Santurce, Puerto Rico
(Address of principal executive offices)

66-0561882
(I.R.S. employer
identification number)
00908
(Zip Code)
(787) 729-8200
(Registrant s telephone number, including area code)
Not applicable
(Former name, former address and former fiscal year, if changed since last report)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or $15(\mathrm{~d})$ of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No $p$ Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in rule 12b-2 of the Exchange Act).

Large accelerated filer p Accelerated filer o Non-accelerated filer o
Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act). Yes o No p
Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.
Common stock: 83,254,056 outstanding as of June 30, 2007.

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## EXPLANATORY NOTE

First BanCorp ( the Corporation or First BanCorp ) was unable to timely file with the Securities and Exchange Commission ( SEC ) this Quarterly Report on Form 10-Q for the interim period ended September 30, 2006 and the Quarterly Reports on Form 10-Q for the interim periods ended June 30, 2006, March 31, 2006, September 30, 2005 and June 30, 2005 as a result of the delay in completing the restatement of the Corporation s audited financial statements for the years ended December 31, 2004, 2003 and 2002, and the unaudited selected quarterly financial information for each of the four quarters of 2004, 2003 and 2002, which resulted in delays in the filing of an amendment of First BanCorp s Annual Report on Form 10-K for the year ended December 31, 2004 and consequent delays in the filing of the Corporation s subsequent reports. For information regarding the restatement of First BanCorp s previously issued financial statements, see the Corporation s Amendment No. 1 to Annual Report on Form 10-K/A for the year ended December 31, 2004, which was filed with the SEC on September 26, 2006, and Note 1
Restatement of Previously Issued Financial Statements to the accompanying unaudited Consolidated Financial Statements contained in this Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2006.

## FORWARD LOOKING STATEMENTS

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

First BanCorp wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made, and represent First BanCorp s expectations of future conditions or results and are not guarantees of future performance. First BanCorp advises readers that various factors could cause actual results to differ materially from those contained in any forward-looking statement. Such factors include, but are not limited to, the following:
risks associated with the Corporation s inability to prepare and timely submit SEC and other regulatory filings;
a reduction in the Corporation s ability to attract new clients and retain existing ones;
general economic conditions, including prevailing interest rates and the performance of the financial markets, which may affect demand for the Corporation s products and services and the value of the Corporation sassets, including the value of the interest rate swaps that hedge the interest rate risk mainly relating to brokered certificates of deposit and medium-term notes;
risks arising from worsening economic conditions in Puerto Rico;
risks arising from credit and other risks of the Corporation s lending and investment activities, including the condo conversion loans in its Miami Agency;
increases in the Corporation sexpenses associated with acquisitions and dispositions;
developments in technology;
risks associated with changes to the Corporation s business strategy to no longer acquire mortgage loans in bulk;
risks associated with the failure to obtain a final order from the District Court of Puerto Rico approving the settlement of the class-action lawsuit brought against the Corporation;

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the impact of Doral Financial Corporation financial condition on its repayment of its outstanding secured loan to the Corporation;
risks associated with being subject to the cease and desist order;
potential further 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 First BanCorp s 2005 Annual Report on Form 10-K and under Item 1A, Risk Factors, in this Quarterly Report on Form 10-Q.

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FIRST BANCORP
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited)


Loans, net of allowance for loan and lease losses of \$150,924,964 (December 31, 2005-\$147,998,733;
September 30, 2005 -
\$147,267,275; September 30, 2004-\$137,253,064)
Loans held for sale, at lower of cost or market

Total loans, net
Premises and equipment, net Other real estate owned Accrued interest receivable on loans and investments Due from customers on acceptances
Other assets
Total assets

## Liabilities \& Stockholders

## Equity

Liabilities:
Non-interest-bearing deposits Interest-bearing deposits Federal funds purchased and securities sold under agreements to repurchase Advances from the Federal Home Loan Bank (FHLB) Notes payable
Other borrowings
Subordinated notes
Bank acceptance outstanding
Payable for unsettled investment trade Accounts payable and other liabilities

Total liabilities
$16,163,426,973$
$18,719,809,792$
18,017,233,434
$14,009,297,111$

$$
\begin{array}{rrrrrr}
\$ 676,027,822 & \$ 811,006,126 & \$ & 751,689,852 & \$ & 603,713,284 \\
11,205,497,022 & 11,652,746,080 & 11,501,114,323 & & 6,753,832,707 \\
& & & & \\
& & & & \\
& & & & \\
& & & & \\
& 228,435,000 & 4,833,882,000 & 470,696,000 & & 4,558,915,656 \\
& & & & \\
134,000,000 & 506,000,000 & 448,000,000 & 1,373,000,000 \\
231,575,237 & 178,693,249 & 178,419,384 & 152,901,700 \\
231,694,859 & 231,622,020 & 231,597,474 & 276,667,705 \\
& & 82,684,827 & 82,137,249 \\
531,416 & 353,864 & 397,538 & 717,930
\end{array}
$$

505,665,617
10,285,040
197,125,840

Commitments and contingencies (Note 17)

Stockholders equity:
Preferred stock, authorized
$550,100,000 \quad 550,100,000$
550,100,000
550,100,000
outstanding 22,004,000 shares at $\$ 25$ liquidation value per share

Common stock, \$1 par value, authorized $250,000,000$ shares; issued $93,151,856$ shares
(December 31, 2005-
90,772,856 shares ;
September 30, 2005 90,772,856 shares;
September 30, 2004 -

| 45,206,555 shares) | $93,151,856$ | $90,772,856$ | $90,772,856$ | $45,206,555$ |
| :--- | :---: | :---: | :---: | ---: |
| Less: Treasury Stock (at par <br> value) | $(9,897,800)$ | $(9,897,800)$ | $(9,897,800)$ | $(4,920,900)$ |
| Common stock outstanding | $83,254,056$ | $80,875,056$ | $80,875,056$ | $40,285,655$ |
|  |  |  |  | $3,209,915$ |
| Additional paid-in capital | $22,756,994$ |  | $82,825,000$ | $80,000,000$ |
| Capital reserve | $265,844,192$ | $265,844,192$ | $183,019,192$ | $165,709,122$ |
| Legal surplus | $331,375,119$ | $316,696,971$ | $357,748,736$ | $292,850,947$ |

Accumulated other comprehensive (loss) income, net of tax benefit (expense) of \$234,362 (December 31, 2005

- \$16,259 ; September 30, 2005
- (\$369,061) ; September 30,

| $2004(\$ 1,131,416))$ | $(28,815,801)$ | $(15,675,284)$ | 191,469 | $40,491,630$ |
| :--- | ---: | ---: | ---: | ---: |
| Total stockholders equity | $1,224,514,560$ | $1,197,840,935$ | $1,254,759,453$ | $1,172,647,269$ |

Total liabilities and
stockholders equity $\$ 17,387,941,533 \quad \$ 19,917,650,727 \quad \$ 19,271,992,887$ \$ 15,181,944,380
The accompanying notes are an integral part of these statements.

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FIRST BANCORP
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

|  | Quarter Ended |  |  |
| :---: | :---: | :---: | :---: |
|  |  |  | $\begin{aligned} & \text { September } \\ & \text { 30, } \end{aligned}$ |
|  | $\begin{gathered} \text { September } \\ \text { 30, } \\ 2006 \end{gathered}$ | $\begin{gathered} \text { September } \\ 30, \\ 2005 \end{gathered}$ | $\begin{gathered} 2004 \\ \text { (As Restated) } \end{gathered}$ |
| Interest income: |  |  |  |
| Loans | \$216,953,076 | \$ 214,006,807 | \$ 115,148,412 |
| Investment securities | 70,490,419 | 71,660,199 | 70,363,002 |
| Money market investments | 30,267,972 | 6,596,601 | 1,152,460 |
| Total interest income | 317,711,467 | 292,263,607 | 186,663,874 |
| Interest expense: |  |  |  |
| Deposits (Note 11) | 135,647,412 | 161,152,342 | $(30,653,464)$ |
| Federal funds purchased and repurchase agreements | 49,412,806 | 48,838,569 | 34,625,138 |
| Advances from FHLB | 2,876,488 | 5,207,707 | 7,573,861 |
| Notes payable and other borrowings | 7,072,733 | 10,321,624 | 4,512,647 |
| Total interest expense | 195,009,439 | 225,520,242 | 16,058,182 |
| Net interest income | 122,702,028 | 66,743,365 | 170,605,692 |
| Provision for loan and lease losses | 20,559,123 | 12,861,207 | 13,199,850 |
| Net interest income after provision for loan and lease losses | 102,142,905 | 53,882,158 | 157,405,842 |
| Non-interest income: |  |  |  |
| Other service charges on loans | 1,227,894 | 1,529,430 | 851,848 |
| Service charges on deposit accounts | 3,025,188 | 3,025,013 | 2,705,111 |
| Mortgage banking activities | 1,595,068 | 318,125 | 1,328,492 |
| Gain on partial extinguishment of a secured commercial |  |  |  |
| loan to a local financial institution | 1,000,000 |  |  |
| Net (loss) gain on investments and impairments | $(6,083,674)$ | 4,517,344 | 360,031 |
| Rental income | 847,343 | 875,408 | 814,398 |
| Other operating income | 6,432,570 | 7,427,195 | 5,631,393 |
| Total non-interest income | 8,044,389 | 17,692,515 | 11,691,273 |


| Non-interest expenses: |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Employees compensation and benefits |  | 32,881,298 |  | 26,838,736 |  | 21,153,090 |
| Occupancy and equipment |  | 13,730,875 |  | 12,842,629 |  | 10,260,593 |
| Business promotion |  | 4,512,400 |  | 4,876,566 |  | 4,354,617 |
| Professional fees |  | 7,407,582 |  | 3,553,065 |  | 1,023,091 |
| Taxes, other than income taxes |  | 3,577,530 |  | 2,577,072 |  | 2,283,388 |
| Insurance and supervisory fees |  | 1,862,433 |  | 1,171,779 |  | 994,620 |
| Other operating expenses |  | 8,967,989 |  | 8,695,503 |  | 5,807,371 |
| Total non-interest expenses |  | 72,940,107 |  | 60,555,350 |  | 45,876,770 |
| Income before income taxes Income tax (provision) benefit |  | $\begin{gathered} 37,247,187 \\ (10,565,431) \end{gathered}$ |  | $\begin{array}{r} 11,019,323 \\ 6,285,264 \end{array}$ |  | $\begin{aligned} & 123,220,345 \\ & (34,826,984) \end{aligned}$ |
| Net income | \$ | 26,681,756 | \$ | 17,304,587 | \$ | 88,393,361 |
| Net income attributable to common stockholders | \$ | 16,612,757 | \$ | 7,235,588 | \$ | 78,324,362 |
| Net income per common share: |  |  |  |  |  |  |
| Basic | \$ | 0.20 | \$ | 0.09 | \$ | 0.97 |
| Diluted | \$ | 0.20 | \$ | 0.09 | \$ | 0.94 |
| Dividends declared per common share | \$ | 0.07 | \$ | 0.07 | \$ | 0.06 |

The accompanying notes are an integral part of these statements.

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## CONSOLIDATED STATEMENTS OF INCOME <br> (Unaudited)

|  | Nine Month Period Ended |  |  |
| :---: | :---: | :---: | :---: |
|  |  |  | $\begin{gathered} \text { September } \\ \text { 30, } \end{gathered}$ |
|  | $\begin{gathered} \text { September } \\ 30, \\ 2006 \end{gathered}$ | $\begin{gathered} \text { September } \\ 30, \\ 2005 \end{gathered}$ | $\begin{gathered} 2004 \\ \text { (As Restated) } \end{gathered}$ |
| Interest income: |  |  |  |
| Loans | \$ 710,646,312 | \$ 541,459,045 | \$ 325,791,945 |
| Investment securities | 214,171,649 | 201,724,546 | 169,875,169 |
| Money market investments | 65,041,845 | 10,613,567 | 2,415,876 |
| Total interest income | 989,859,806 | 753,797,158 | 498,082,990 |
| Interest expense: |  |  |  |
| Deposits (Note 11) | 479,639,216 | 252,840,683 | 71,913,056 |
| Federal funds purchased and repurchase agreements | 154,111,848 | 126,896,352 | 94,816,509 |
| Advances from FHLB | 9,921,291 | 27,497,510 | 18,690,602 |
| Notes payable and other borrowings | 24,428,872 | 21,472,722 | 8,287,120 |
| Total interest expense | 668,101,227 | 428,707,267 | 193,707,287 |
| Net interest income | 321,758,579 | 325,089,891 | 304,375,703 |
| Provision for loan and lease losses | 49,289,600 | 34,889,980 | 39,600,000 |
| Net interest income after provision for loan and lease losses | 272,468,979 | 290,199,911 | 264,775,703 |
| Non-interest income: |  |  |  |
| Other service charges on loans | 4,181,291 | 4,187,995 | 2,957,425 |
| Service charges on deposit accounts | 9,580,326 | 8,736,728 | 8,230,790 |
| Mortgage banking activities | 1,447,392 | 3,888,206 | 3,090,458 |
| Loss on partial extinguishment of a secured commercial |  |  |  |
| loan to a local financial institution | $(10,640,344)$ |  |  |
| Net (loss) gain on investments and impairments | $(6,658,218)$ | 12,849,663 | 4,875,926 |
| Rental income | 2,458,013 | 2,584,232 | 2,133,341 |
| Gain on sale of credit card portfolio |  |  | 5,532,684 |
| Other operating income | 20,047,067 | 19,116,254 | 17,981,078 |
| Total non-interest income | 20,415,527 | 51,363,078 | 44,801,702 |

Non-interest expenses:

| Employees compensation and benefits | 96,875,998 |  | 76,427,208 |  | 62,126,994 |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Occupancy and equipment | 40,060,463 |  | 35,247,619 |  | 29,080,304 |
| Business promotion | 12,610,641 |  | 14,509,582 |  | 12,411,300 |
| Professional fees | 24,943,755 |  | 6,960,961 |  | 2,963,785 |
| Taxes, other than income taxes | 8,690,870 |  | 7,131,394 |  | 6,182,051 |
| Insurance and supervisory fees | 5,472,995 |  | 3,362,138 |  | 3,080,826 |
| Other operating expenses | 27,063,159 |  | 25,996,404 |  | 18,346,305 |
| Total non-interest expenses | 215,717,881 |  | 169,635,306 |  | 134,191,565 |
| Income before income taxes | 77,166,625 |  | 171,927,683 |  | 175,385,840 |
| Income tax provision | $(14,819,125)$ |  | (32,002,088) |  | (39,754,445) |
| Net income | \$ 62,347,500 | \$ | 139,925,595 | \$ | 135,631,395 |
| Net income attributable to common stockholders | \$ 32,140,503 | \$ | 109,718,598 | \$ | 105,424,398 |
| Net income per common share: |  |  |  |  |  |
| Basic | \$ 0.39 | \$ | 1.36 | \$ | 1.31 |
| Diluted | \$ 0.39 | \$ | 1.32 | \$ | 1.27 |
| Dividends declared per common share | \$ 0.21 | \$ | 0.21 | \$ | 0.18 |

The accompanying notes are an integral part of these statements.

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## FIRST BANCORP <br> CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

## Cash flows from operating activities:

Net income
Adjustments to reconcile net income to net cash provided by operating activities:
Depreciation
Amortization of core deposit intangible
Provision for loan and lease losses
Deferred income tax (benefit) provision
Stock-based compensation recognized
Gain on sale of investments, net
Other-than-temporary impairments on available-for-sale securities
Unrealized loss (gain) on derivative instruments
Net gain on sale of loans and impairments
Net loss on partial extinguishment of a secured commercial loan to a local financial institution
Net amortization of premiums and discounts and deferred loan fees and costs
Amortization of broker placement fees
Amortization of basis adjustments on fair value hedges
Net (accretion) of discounts and premiums on investment securities
Amortization of discount on subordinated notes
Gain on sale of credit card portfolio
(Decrease) increase in accrued income tax payable
Decrease (increase) in accrued interest receivable
Increase in accrued interest payable
Decrease (increase) in other assets
Increase in other liabilities
Total adjustments
Net cash provided by operating activities

| $12,566,395$ | $11,179,619$ | $10,474,400$ |
| :---: | :---: | ---: |
| $2,581,437$ | $2,463,235$ | $1,797,465$ |
| $49,289,600$ | $34,889,980$ | $39,600,000$ |
| $(35,605,857)$ | $(17,898,389)$ | 237,561 |
| $5,379,511$ |  |  |
| $(5,431,170)$ | $(14,348,729)$ | $(7,574,918)$ |
|  |  |  |
| $12,089,388$ | $1,499,066$ | $2,698,992$ |
| $64,025,985$ | $39,977,961$ | $(23,644,682)$ |
| $(1,063,882)$ | $(3,635,744)$ | $(2,873,893)$ |

$10,640,344$
(2,045,780)
15,228,471
458,374
(26,242,786)
(42,621,586)
2,543,241
26,564,232
4,922,947
17,353,014
110,631,878
172,979,378

| $5,209,573,268$ | $2,522,641,911$ |
| ---: | ---: |
| $(3,491,295,450)$ | $(4,580,927,938)$ |
| $(134,310,032)$ | $(317,031,608)$ | (7,574,918)

2,698,992
$(23,644,682)$
$(2,873,893)$

1,736,639
10,228,646
(20,521,612)
371,861
$(5,532,684)$
$(6,013,033)$
$(19,408,552)$
6,294,948
(20,475,269)
23,331,745
$(9,272,386)$
126,359,009
(134,310,032)
$(317,031,608)$
1,664,761,267
(3,327,844,911)
(147,976,311)

September 30,
2004
(As Restated)
\$ 139,925,595
\$ 135,631,395
\$ 62,347,500

## September 30, 2006

Nine Month Period Ended
September 30, 2005

## Cash flows from investing activities:

Principal collected on loans
Loans originated
Purchase of loans

Proceeds from sale of loans
Proceeds from sale of repossessed assets
Purchase of servicing assets
Proceeds from sale of available for sale securities Purchase of securities held to maturity
Purchase of securities available for sale Principal repayments and maturities of securities held to maturity
Principal repayments of securities available for sale Additions to premises and equipment
Decrease (increase) in other equity securities
Cash paid for net assets acquired in acquisition of business

Net cash provided by (used in) investing activities

## Cash flows from financing activities:

Net (decrease) increase in deposits
Net (decrease) increase in federal funds purchased and securities sold under repurchase agreements Net FHLB advances (paid) taken
Net proceeds from issuance of notes payable and other borrowings
Repayments of notes payable and other borrowings
Dividends paid
Exercise of stock options
Treasury stock acquired
Net cash (used in) provided by financing activities
Net (decrease) increase in cash and cash equivalents
Cash and cash equivalents at beginning of period
Cash and cash equivalents at end of period
Cash and cash equivalents include:
Cash and due from banks
Money market instruments

## Supplemental disclosures of cash flow information:

Cash paid during the period for:
Interest on borrowings
Income Taxes
Non-cash investing and financing activities:
Additions to other real estate owned
$116,214,827$
$32,988,920$
$(723,779)$
228,122,652
$(402,607,038)$
(225,372,830)
509,566,831
168,697,285
(47,698,610)
21,378,315

1,984,534,359
(2,654,155,200)
(2,396,761,287)

| $(651,589,392)$ | 3,892,017,199 |  | 577,444,682 |
| :---: | :---: | :---: | :---: |
| $\begin{array}{r} (1,605,447,000) \\ (372,000,000) \end{array}$ | 303,335,087 |  | 919,443,313 |
|  | (1,190,000,000) |  | 460,000,000 |
|  |  |  | 429,409,766 |
|  | $(45,167,616)$ |  |  |
| $(47,669,352)$ | $(47,184,548)$ |  | (44,684,441) |
| 19,756,483 | $\begin{gathered} 2,094,354 \\ (965,079) \end{gathered}$ |  | 3,199,430 |
| (2,656,949,261) | 2,914,129,397 |  | 2,344,812,750 |
| (499,435,524) | 490,770,604 |  | 74,410,472 |
| 1,380,640,086 | 926,975,163 |  | 1,052,107,837 |
| \$ 881,204,562 | \$ 1,417,745,767 | \$ | 1,126,518,309 |
| \$ 81,983,261 | \$ 137,248,464 | \$ | 91,317,992 |
| 799,221,301 | 1,282,497,303 |  | 1,035,200,317 |
| \$ 881,204,562 | \$ 1,419,745,767 | \$ | 1,126,518,309 |

120,682,234
24,737,292
109,704,058
23,556,754
32,845,372
(1,547,072,399)
$(495,451,907)$
1,056,932,801
270,854,574
(14,070,585)
$(23,000,000)$
(78,404,804)
$1,984,534,359 \quad(2,654,155,200)$
(2,396,761,287)

429,409,766
(44,684,441)
3,199,430

2,344,812,750
74,410,472
1,052,107,837
\$ 1,126,518,309

| Additions to auto repossessions | $86,020,776$ | $45,952,789$ | $31,032,738$ |
| :--- | ---: | ---: | ---: |
| Capitalization of servicing assets | 851,591 | $1,480,900$ | $1,459,800$ |
| Mortgage loans securitized and transferred to |  |  | $51,107,154$ |
| securities available-for-sale |  |  |  |

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## FIRST BANCORP

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (Unaudited)

|  | Nine Month Period Ended |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { September 30, } \\ 2006 \end{gathered}$ | $\begin{gathered} \text { September 30, } \\ 2005 \end{gathered}$ |  | $\begin{gathered} \text { September 30, } \\ 2004 \end{gathered}$ |  |
|  |  |  |  |  | Restated) |
| Preferred Stock |  | \$ |  | \$ | 550,100,000 |
| Common Stock outstanding: |  |  |  |  |  |
| Balance at beginning of period | 80,875,056 |  | 40,389,155 |  | 40,027,285 |
| Common stock issued under stock option plan | 2,379,000 |  | 76,373 |  | 258,370 |
| Treasury stock acquired before stock split |  |  | $(28,000)$ |  |  |
| Shares issued as a result of stock split |  |  | 40,437,528 |  |  |
| Balance at end of period | 83,254,056 |  | 80,875,056 |  | 40,285,655 |
| Additional Paid-In-Capital: |  |  |  |  |  |
| Balance at beginning of period |  |  | 4,863,299 |  | 268,855 |
| Shares issued under stock option plan | 17,377,483 |  | 2,017,981 |  | 2,941,060 |
| Stock-based compensation recognized | 5,379,511 |  |  |  |  |
| Treasury stock acquired |  |  | $(937,079)$ |  |  |
| Adjustment for stock split |  |  | (5,944,201) |  |  |
| Balance at end of period | 22,756,994 |  |  |  | 3,209,915 |
| Capital Reserve |  |  | 82,825,000 |  | 80,000,000 |
| Legal Surplus | 265,844,192 |  | 183,019,192 |  | 165,709,122 |
| Retained Earnings: |  |  |  |  |  |
| Balance at beginning of period | 316,696,971 |  | 299,501,016 |  | 201,903,993 |
| Net income | 62,347,500 |  | 139,925,595 |  | 135,631,395 |
| Cash dividends declared on common stock | $(17,462,355)$ |  | $(16,977,551)$ |  | $(14,477,444)$ |
| Cash dividends declared on preferred stock | $(30,206,997)$ |  | $(30,206,997)$ |  | $(30,206,997)$ |
| Adjustment for stock split |  |  | $(34,493,327)$ |  |  |
| Balance at end of period | 331,375,119 |  | 357,748,736 |  | 292,850,947 |

## Accumulated Other Comprehensive (Loss)

Income, net of tax:

| Balance at beginning of period | $(15,675,284)$ | $43,635,624$ | $35,812,500$ |  |
| :--- | ---: | ---: | ---: | ---: |
| Other comprehensive (loss) income, net of tax | $(13,140,517)$ | $(43,444,155)$ | $4,679,130$ |  |
| Balance at end of period | $(28,815,801)$ | 191,469 | $40,491,630$ |  |
|  |  |  |  |  |
| Total stockholders equity | $\$ 1,224,514,560$ | $\$$ | $1,254,759,453$ | $\$$ |

The accompanying notes are an integral part of these statements.
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## FIRST BANCORP <br> CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

|  |  | Quarter Ended |
| :---: | :---: | :---: | :---: |
| September |  |  |
| 30, |  |  |

Other comprehensive income (loss):
Unrealized gain (loss) on securities:
Unrealized holding gain (loss) arising during the period Less: Reclassification adjustments for net loss (gain) and other than temporary impairments included in net income 48,411,623 (32,042,194) 18,839,245 Income tax (expense) benefit related to items of other comprehensive income

$$
6,083,674 \quad(4,517,344)
$$

$(675,834) \quad 762,753$

Other comprehensive income (loss) for the period, net of tax

The accompanying notes are an integral part of these statements.

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# FIRST BANCORP <br> CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited) 

|  |  | Nine Month Period Ended |  |
| :---: | :---: | :---: | :---: |
|  |  |  | September |
| 30, |  |  |  |
|  | September | September |  |
|  | $\mathbf{3 0}$ | $\mathbf{3 0 ,}$ | $\mathbf{2 0 0 4}$ |
| Net income | $\mathbf{2 0 0 6}$ | $\mathbf{2 0 0 5}$ | (As Restated) |
|  | $\$ 62,347,500$ | $\$ 139,925,595$ | $\$ 135,631,395$ |

Other comprehensive (loss) income:
Unrealized (loss) gain on securities:
Unrealized holding (loss) gain arising during the period Less: Reclassification adjustments for net loss (gain) and other than temporary impairments included in net income Income tax benefit (expense) related to items of other comprehensive income

| $(20,016,838)$ | $(31,119,827)$ | $10,073,391$ |
| ---: | ---: | ---: |
| $6,658,218$ | $(12,849,663)$ | $(4,875,926)$ |
| 218,103 | 525,335 | $(518,335)$ |

Other comprehensive (loss) income for the period, net of tax
$(13,140,517) \quad(43,444,155)$
4,679,130

Total comprehensive income
\$ 49,206,983 \$ 96,481,440 \$ 140,310,525

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## FIRST BANCORP <br> PART I NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 1 RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

As previously reported, on December 13, 2005 the Corporation concluded that its financial statements for the interim and annual periods from January 1, 2000 through March 31, 2005 should no longer be relied upon and that its consolidated financial statements for some or all of the periods included therein should be restated (the 2004 restatement ). On September 26, 2006, the Corporation filed with the SEC an Amended Annual Report on Form 10-K/A restating its audited financial statements for the years ended December 31, 2004, 2003 and 2002. The following provides a brief description of the principal accounting adjustments included in the 2004 restatement of the Corporation s consolidated financial statements and the effect of the adjustments on the Corporation s Consolidated Statement of Financial Condition as of September 30, 2004, its Consolidated Statements of Income for the quarter and nine month period ended September 30, 2004 and its Consolidated Statement of Cash Flows for the nine month period ended September 30, 2004. In addition, with the filing of its 2006 Annual Report on Form 10-K, First BanCorp restated its 2005 and 2004 Statements of Cash Flows due to some incorrect classifications. The classification errors related to three main items: 1) the treatment of discounts and the related accretion activity on certain investment securities (mostly zero coupon securities ), 2) the classification of cash flows from the disposition of repossessed assets, and 3) purchases of zero coupon bonds and agency discount notes amounts presented as part of investing activities (the 2006 restatement ). All financial information for the quarter and nine month period ended September 30, 2004 included in any subsequent notes is presented on a restated basis. A more detailed description of the accounting adjustments made in connection with the 2004 restatement, as well as a background discussion of the 2004 restatement, is included in Note 1 Restatement of Previously Issued Financial Statements to First Bancorp audited Consolidated Financial Statements, included in the Corporation s amended 2004 Annual Report on Form 10-K. A more detailed description of the accounting adjustments made in connection with the 2006 restatement, is included in Note 1 Restatement of 2005 and 2004 Consolidated Statements of Cash Flows to First BanCorp audited Consolidated Financial Statements, included in the Corporation s 2006 Annual Report on Form 10-K.

As discussed in more detail below, First BanCorp has separately quantified the impact of various accounting adjustments on its interim unaudited Consolidated Financial Statements.

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## RECONCILIATION OF PREVIOUSLY REPORTED TO RESTATED FIGURES CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

As of ..... September 30,
2004
(In thousands)\$91,318
Money market investments, as previously reported ..... \$ 1,023,910
Impact of accounting errors and corrections:
Reclassifications ..... 11,290
Money market investments, as restated\$ 1,035,200
Investment securities including FHLB Stock, as previously reported ..... \$ 5,350,974
Impact of accounting errors and corrections:
Accounting for investment securities ..... 771
Recharacterization of pass-through certificates as secured loans ..... $(143,246)$
Reclassifications ..... $(11,290)$
Investment securities including FHLB stock, as restated ..... \$ 5,197,209
Total loans, net of allowance for loan and lease losses, as previously reported ..... \$ ..... 8,365,028 Impact of accounting errors and corrections:
Accounting for derivative instruments and broker placement fees(210)
Accounting for origination fees and costs and premiums and discounts on loans ..... $(2,267)$
Recharacterization of pass-through certificates as secured loans ..... 143,246
Reclassifications ..... 492
Other accounting adjustments ..... $(2,444)$
Total loans, net of allowance for loan and lease losses, as restated ..... \$ 8,503,845
Total other assets, as previously reported ..... \$ ..... 346,430
Impact of accounting errors and corrections:
Accounting for derivative instruments and broker placement fees ..... (475)
Tax impact of accounting adjustments ..... 7,259
Reclassifications ..... (488)
Valuation of financial instruments ..... 1,200
Other accounting adjustments ..... 446
Total liabilities, as previously reported ..... \$ 13,994,207
Impact of accounting errors and corrections:
Accounting for derivative instruments and broker placement fees ..... 13,863
Tax impact of accounting adjustments ..... 2,392
Reclassifications ..... 4
Other accounting adjustments ..... $(1,169)$
Total liabilities, as restated ..... \$ 14,009,297
Stockholders equity, as previously reported ..... \$ 1,183,453
Impact of accounting errors and corrections:
Accounting for derivative instruments and broker placement fees$(15,211)$
Accounting for investment securities ..... 3,121
Accounting for origination fees and costs and premiums and discounts on loans ..... $(2,267)$
Valuation of financial instruments ..... 1,200
Tax impact of accounting adjustments ..... 4,866
Impact of accounting adjustments in other comprehensive income ..... $(1,686)$
Other accounting adjustments ..... (829)
Stockholders equity, as restated ..... \$ 1,172,647

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## RECONCILIATION OF PREVIOUSLY REPORTED TO RESTATED FIGURES CONSOLIDATED STATEMENT OF INCOME

|  | Quarter Ended September 30, 2004 |  | Nine Month Period Ended <br> September 30, 2004 |  |
| :---: | :---: | :---: | :---: | :---: |
| (In thousands, except per share amounts) |  |  |  |  |
| Net interest income, as previously reported | \$ | 103,272 | \$ | 281,753 |
| Impact of accounting errors and corrections: |  |  |  |  |
| Accounting for derivative instruments and broker placement fees |  | 58,924 |  | 11,761 |
| Accounting for investment securities |  | 6,043 |  | 1,731 |
| Accounting for origination fees and costs and premiums and discounts on loans |  | 241 |  | 535 |
| Reclassification of late charges, penalty fees on loans and other |  | 2,561 |  | 8,803 |
| Other accounting adjustments |  | (435) |  | (207) |
| Net interest income, as restated | \$ | 170,606 | \$ | 304,376 |
| Provision for loan and lease losses (no adjustment required) | \$ | 13,200 | \$ | 39,600 |
| Non-interest income, as previously reported | \$ | 15,722 | \$ | 53,370 |
| Impact of accounting errors and corrections: |  |  |  |  |
| Accounting for derivative instruments and broker placement fees |  | (763) |  | 623 |
| Accounting for origination fees and costs and premiums and discounts on loans |  | (721) |  | $(2,020)$ |
| Reclassification of late charges, penalty fees on loans and other |  | $(2,561)$ |  | $(8,803)$ |
| Valuation of financial instruments |  |  |  | 1,200 |
| Other accounting adjustments |  | 15 |  | 432 |
| Non-interest income, as restated | \$ | 11,692 | \$ | 44,802 |
| Non-interest expenses, as previously reported | \$ | 45,976 | \$ | 134,644 |
| Impact of accounting errors and corrections: |  |  |  |  |
| Accounting for origination fees and costs and premiums and discounts on loans |  | (280) |  | (805) |
| Other accounting adjustments |  | 181 |  | 353 |

Non-interest expenses, as restated

Income tax expense, as previously reported
\$ 45,877 \$
134,192

Impact of accounting errors and corrections

Income tax expense, as restated

| Net income, as restated | $\$$ | 88,393 | $\$$ | 135,631 |
| :--- | :---: | :---: | :---: | :---: |
|  |  |  |  | 1.23 |
| Basic earnings per common share, as previously reported <br> Effect of adjustments | $\$$ | 0.48 | $\$$ | 0.08 |
| Basic earnings per common share, as restated |  | 0.49 |  | 1.31 |
|  | $\$$ | 0.97 | $\$$ | 1.20 |
| Diluted earnings per common share, as previously reported | $\$$ | 0.47 | $\$$ | 0.07 |
| Effect of adjustments |  | 0.47 |  | 1.27 |

The Corporation classified the accounting practices and related adjustments that were affected by the restatement into the categories described below.
Accounting for Derivative Instruments and Broker Placement Fees. As part of the restatement, the Corporation reviewed its accounting for derivative instruments and concluded that its use of the short-cut method of hedge accounting under Statement of Financial Accounting Standard No. ( SFAS ) 133, Accounting for Derivative Instruments and Hedging Activities, for interest rate swaps that economically hedge mainly brokered certificates of deposit ( CDs ) was not consistent with generally accepted accounting principles in the United States of America ( GAAP ) because the fee received from the swap counterparty at the inception of the relationship caused the swap not to have a fair value of zero at inception (which is required under SFAS 133 to qualify for the short-cut

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method). In connection with the evaluation of hedge accounting transactions, the Corporation concluded that the short-cut method was also incorrectly used for certain interest rate swaps hedging medium-term notes, certain corporate bonds and certain commercial loan receivables.

Prior to the restatement, the Corporation recorded, under the short-cut method, the effective portion of the change in fair value of the hedged item as an adjustment to income that offsets the fair value adjustment on the related interest rate swap. Furthermore, prior to the restatement, the broker placement fees were offset with the upfront fees received from the swap counterparties at inception with no separate accounting recognition.

The adjustments related to the correction of the accounting for derivative instruments and broker placement fees primarily consisted of: (1) eliminating the fair value adjustments previously made to the brokered CDs, medium-term notes and other hedged items; (2) recognizing the fair value of the interest rate swaps at inception, which is the equivalent of the upfront fees received from swap counterparties; (3) recognizing the placement fees paid to the brokers that placed the brokered CDs and medium-term notes as deferred costs required to be amortized over the expected maturities of the related economically hedged items; and (4) correcting the fair value of the interest rate swaps as of the end of each reporting period.

The net cumulative pre-tax effect through September 30, 2004 related to the correction of the accounting for derivative instruments and broker placement fees was a decrease of $\$ 15.2$ million. The following table details the components of the pre-tax income effect from the correction in the accounting for interest rate swaps and broker placement fees for the quarter and nine month period ended September 30, 2004:

|  | Quarter Ended <br> September 30, <br> 2004 | Nine Month Period <br> Ended |  |  |
| :--- | :---: | :---: | :---: | :---: |
| September 30, 2004 |  |  |  |  |
| Elimination of fair value adjustments previously made to hedged | $\$$ | 61,661 | $\$$ | 12,507 |
| items | 3,727 |  | 16,468 |  |
| Recognition of interest rate swap up-front fees | $(3,351)$ | $(8,886)$ |  |  |
| Broker placement fees amortization | $(3,876)$ | $(7,705)$ |  |  |
| Corrections to interest rate swap valuations |  | 58,161 | $\$$ | 12,384 |

Recharacterization of purchases of mortgage loans and pass-through trust certificates as commercial loans secured by mortgage loans. Prior to the restatement, the Corporation had inaccurately recorded as purchases of residential mortgages, commercial mortgage loans and pass-through trust certificates certain mortgage-related transactions with local financial institutions. Certain of these transactions included or likely included recourse provisions, which had not been analyzed as part of the Corporation s financial reporting process. The Corporation determined that such transactions did not satisfy the reasonable assurance standard of SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities , regarding the isolation of assets in bankruptcy, with the result that they did not qualify as a true sale for accounting purposes. The restatement reflects these mortgage-related transactions as commercial loans secured by mortgage loans and pass-through trust certificates. This conclusion resulted in the revised classification of approximately $\$ 3.1$ billion in mortgage-related loans to secured loans to local financial institutions as of September 30, 2004 and $\$ 143.2$ million pass-through trust certificates to secured loans to local financial institutions as of September 30, 2004. The recharacterization of the mortgage-related transactions did not impact the Corporation s retained earnings as of September 30, 2004.
Accounting for Investment Securities. The Corporation historically amortized premiums and discounts related to most of its investment securities into interest income over the life of the related securities using a straight-line method adjusted for prepayment of securities. As part of the restatement, the Corporation concluded that it needed to correct its methodology and adjust its financial statements to reflect the amortization of premiums and discounts into interest income over the terms of the securities using the effective interest method instead of the straight-line method. The
cumulative effect of this correction on the Corporation s pre-tax income through September 30, 2004 15

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was an increase of $\$ 3.1$ million. For the quarter and nine month period ended September 30, 2004, the effect for the correction of the accounting for investment securities was an increase on the Corporation s pre-tax income of $\$ 6.0$ million and $\$ 1.7$ million, respectively.

In addition, the Corporation identified other types of investment instruments that had not been recognized in the Consolidated Statement of Financial Condition in accordance with the provisions of SFAS 115 Accounting for Certain Investments in Debt and Equity Securities.
Accounting for deferral and recognition of origination fees and costs on loans. As part of the restatement process, the Corporation reviewed the methodology used to measure origination fees and costs associated with its loans origination, in accordance with SFAS 91, Accounting for Nonrefundable Fees and Costs Associated with Origination or Acquiring Loans and Initial Direct Costs of Leases , which establishes the accounting treatment for nonrefundable fees and costs associated with lending, committing to lend or purchasing loans. The Corporation concluded that throughout the restatement period, it did not apply SFAS 91 requirements to one of its consumer loans portfolios. Accordingly, the Corporation concluded that, in order to comply with SFAS 91, it needed to defer and amortize loan origination fees and costs on this portfolio using the interest method. The cumulative effect of this correction on the Corporation s pre-tax income through September 30, 2004 was a decrease of approximately $\$ 2.3$ million, of which $\$ 0.2$ million and $\$ 0.7$ million was recorded as a reduction in pre-tax income for the quarter and nine month period ended September 30, 2004, respectively.
Valuation of financial instruments. In connection with a loan restructuring, First BanCorp became the holder of warrants. The warrant certificate gives the Corporation the right to purchase common stock from a privately held company at a fixed price. This transaction was not formally evaluated or documented as part of the Corporation s financial reporting process. As part of the restatement process, the Corporation concluded that this transaction meets the definition of a derivative instrument as stated in SFAS 133. Accordingly, the warrant was marked to market and the valuation recognized in earnings as part of Other operating income. The cumulative effect of this correction on the Corporation s pre-tax income through September 30, 2004 was an increase of $\$ 1.2$ million, all of which related to the quarter ended March 31, 2004.
Other Accounting Adjustments and Reclassifications. As part of the restatement, the Corporation also made corrections to various other aspects of its Consolidated Financial Statements, including adjustments to the gain on sale of credit card portfolios, accrual of rental expense on lease contracts and income from a loan origination subsidiary. The cumulative effect of all these other adjustments on the Corporation s pre-tax income through September 30, 2004 was a decrease of $\$ 0.8$ million, of which approximately $\$ 0.6$ million was recorded as a decrease to pre-tax income for the quarter ended September 30, 2004 and $\$ 0.1$ million was recorded as a decrease to pre-tax income for the nine month period ended September 30, 2004.

The reclassifications made to conform to GAAP included, among other things, reclassifying late charges and prepayment fees on loans from non-interest income to interest income on loans, and reclassifying dividends on equity securities from non-interest income to interest income on investments. Other reclassifications included reclassifying loans receivable balances within loan categories, reclassifying certain amounts previously reported as repurchase agreements to other borrowings, and reclassifying certain short-term investments previously reported as part of the available for sale and held to maturity investment portfolio to money market investments.
Income Taxes. As a result of the corrections reflected in the restatement, the Corporation s cumulative income tax expense through September 30, 2004 was reduced by approximately $\$ 4.9$ million, of which $\$ 24.1$ million was recorded as an increase to income tax expense for the quarter ended September 30, 2004 and $\$ 8.1$ million was recorded as an increase to income tax expense for the nine month period ended September 30, 2004. The cumulative reduction through September 30, 2004 resulted principally from changes in deferred taxes. See Note 15 for additional details regarding the Corporation $s$ income taxes.

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The following table shows the impact of all restatement adjustments on the previously reported unaudited Consolidated Statement of Financial Condition as of September 30, 2004.

## FIRST BANCORP

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited)

| (Dollars in thousands) | September 30, 2004 <br> (As Previously Reported) |  | Adjustments |  | September 30, 2004 <br> (As Restated) |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Assets |  |  |  |  |  |  |
| Cash and due from banks | \$ | 91,318 |  | \$ | \$ | 91,318 |
| Money market instruments |  | 721,310 |  | 11,290 |  | 732,600 |
| Federal funds sold and securities purchased under agreements to resell |  | 302,000 |  |  |  | 302,000 |
| Time deposits with other financial institutions |  | 600 |  |  |  | 600 |
| Total money market investments |  | 1,023,910 |  | 11,290 |  | 1,035,200 |
| Investment securities available for sale, at fair value: |  |  |  |  |  |  |
| Securities pledged that can be repledged |  | 1,270,255 |  | $(44,413)$ |  | 1,225,842 |
| Other investment securities |  | 350,923 |  | $(99,252)$ |  | 251,671 |
| Total investment securities available for sale |  | 1,621,178 |  | $(143,665)$ |  | 1,477,513 |
| Investment securities held to maturity, at amortized cost: |  |  |  |  |  |  |
| Securities pledged that can be repledged |  | 3,289,813 |  | 725 |  | 3,290,538 |
| Other investment securities |  | 371,333 |  | $(11,200)$ |  | 360,133 |
| Total investment securities held to maturity |  | 3,661,146 |  | $(10,475)$ |  | 3,650,671 |
| Other equity securities |  | 68,650 |  | 375 |  | 69,025 |
| Loans, net of allowance for loan and lease losses |  | 8,357,609 |  | 138,817 |  | 8,496,426 |
| Loans held for sale, at lower of cost or market |  | 7,419 |  |  |  | 7,419 |
| Total loans, net |  | 8,365,028 |  | 138,817 |  | 8,503,845 |
| Premises and equipment, net |  | 88,866 |  |  |  | 88,866 |
| Other real estate owned |  | 6,939 |  |  |  | 6,939 |
| Accrued interest receivable |  | 61,181 |  | (236) |  | 60,945 |
| Due from customers on acceptances |  | 718 |  |  |  | 718 |
| Other assets |  | 188,726 |  | 8,178 |  | 196,904 |
| Total assets | \$ | 15,177,660 |  | \$ 4,284 | \$ | 15,181,944 |

## Liabilities \& Stockholders Equity

Liabilities:

| Non-interest-bearing deposits | \$ | 603,713 | \$ |  | \$ | 603,713 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest-bearing deposits |  | 6,764,318 |  | $(10,485)$ |  | 6,753,833 |
| Federal funds purchased and securities sold under agreements to repurchase |  | 4,614,109 |  | $(55,194)$ |  | 4,558,915 |
| Advances from the Federal Home Loan Bank (FHLB) |  | 1,373,000 |  |  |  | 1,373,000 |
| Notes payable |  | 153,551 |  | (649) |  | 152,902 |
| Other borrowings |  | 231,500 |  | 45,168 |  | 276,668 |
| Subordinated notes |  | 82,821 |  | (684) |  | 82,137 |
| Bank acceptance outstanding |  | 718 |  |  |  | 718 |
| Payable for unsettled investment trade |  | 10,285 |  |  |  | 10,285 |
| Accounts payable and other liabilities |  | 160,192 |  | 36,934 |  | 197,126 |
| Total liabilities |  | 13,994,207 |  | 15,090 |  | 14,009,297 |
| Stockholders equity: |  |  |  |  |  |  |
| Preferred stock, authorized 50,000,000 shares: issued and outstanding 22,004,000 shares at $\$ 25$ |  |  |  |  |  |  |
| liquidation value per share |  | 550,100 |  |  |  | 550,100 |
| Common stock, \$1 par value, authorized |  |  |  |  |  |  |
| $250,000,000$ shares; issued 45,206,555 shares |  | 45,207 |  |  |  | 45,207 |
| Less: Treasury Stock (at par value) |  | $(4,921)$ |  |  |  | $(4,921)$ |
| Common stock outstanding |  | 40,286 |  |  |  | 40,286 |
| Additional paid-in capital |  | 3,210 |  |  |  | 3,210 |
| Capital reserve |  | 80,000 |  |  |  | 80,000 |
| Legal surplus |  | 163,107 |  | 2,602 |  | 165,709 |
| Retained earnings |  | 304,573 |  | $(11,722)$ |  | 292,851 |
| Accumulated other comprehensive income, net of tax |  | 42,177 |  | $(1,686)$ |  | 40,491 |
| Total stockholders equity |  | 1,183,453 |  | $(10,806)$ |  | 1,172,647 |
| Total liabilities and stockholders equity | \$ | 15,177,660 | \$ | 4,284 | \$ | 15,181,944 |

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The following tables show the impact of all restatement adjustments on the previously reported unaudited Consolidated Statements of Income and basic and diluted earnings per share for the quarter and nine month period ended September 30, 2004.

FIRST BANCORP

## CONSOLIDATED STATEMENTS OF INCOME

## (Unaudited)

$\left.\begin{array}{lcccc} & & \text { Quarter Ended } \\ \text { September } \\ \text { September }\end{array}\right)$

| Non-interest expenses: |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Employees compensation and benefits |  | 21,433 |  | (280) |  | 21,153 |
| Occupancy and equipment |  | 10,223 |  | 37 |  | 10,260 |
| Business promotion |  | 4,354 |  |  |  | 4,354 |
| Professional fees |  | 1,024 |  |  |  | 1,024 |
| Taxes, other than income taxes |  | 2,283 |  |  |  | 2,283 |
| Insurance and supervisory fees |  | 995 |  |  |  | 995 |
| Other operating expenses |  | 5,664 |  | 144 |  | 5,808 |
| Total non-interest expenses |  | 45,976 |  | (99) |  | 45,877 |
| Income before income tax Income tax provision |  | $\begin{gathered} 59,818 \\ (10,737) \end{gathered}$ |  | $\begin{gathered} 63,403 \\ (24,091) \end{gathered}$ |  | $\begin{aligned} & 123,221 \\ & (34,828) \end{aligned}$ |
| Net income | \$ | 49,081 | \$ | 39,312 | \$ | 88,393 |
| Net income attributable to common stockholders | \$ | 39,012 | \$ | 39,312 | \$ | 78,324 |
| Net income per common share: |  |  |  |  |  |  |
| Basic | \$ | 0.48 | \$ | 0.49 | \$ | 0.97 |
| Diluted | \$ | 0.47 | \$ | 0.47 | \$ | 0.94 |

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## Non-interest expenses:

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| Employees compensation and benefits | 62,932 |  | (805) |  | 62,127 |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Occupancy and equipment | 29,054 |  | 26 |  | 29,080 |
| Business promotion | 12,411 |  |  |  | 12,411 |
| Professional fees | 2,964 |  |  |  | 2,964 |
| Taxes, other than income taxes | 6,182 |  |  |  | 6,182 |
| Insurance and supervisory fees | 3,081 |  |  |  | 3,081 |
| Other operating expenses | 18,020 |  | 327 |  | 18,347 |
| Total non-interest expenses | 134,644 |  | (452) |  | 134,192 |
| Income before income tax | 160,879 |  | 14,507 |  | 175,386 |
| Income tax provision | $(31,659)$ |  | $(8,096)$ |  | $(39,755)$ |
| Net income | \$ 129,220 | \$ | 6,411 | \$ | 135,631 |
| Net income attributable to common stockholders | \$ 99,013 | \$ | 6,411 | \$ | 105,424 |
| Net income per common share: |  |  |  |  |  |
| Basic | \$ 1.23 | \$ | 0.08 | \$ | 1.31 |
| Diluted | \$ 1.20 | \$ | 0.07 | \$ | 1.27 |

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## Restatement of 2004 Consolidated Statement of Cash Flows

During the preparation of the 2006 consolidated financial statements, management became aware of some incorrect classifications in the Consolidated Statements of Cash Flows for the years ended December 31, 2005 and 2004. The classification errors related to three main items: 1) the treatment of discounts and the related accretion activity on certain investment securities (mostly zero coupon securities ) purchased by the Corporation which were incorrectly presented as cash flows related to investing activities ( principal repayments and maturities of securities held-to-maturity ), instead of operating activities ( net amortization or accretion of discounts and premiums on investment securities ), 2) the classification of cash flows from the disposition of repossessed assets which was included as part of operating activities ( decrease or increase in other assets ), instead of investing activities ( proceeds from sale of repossessed assets ), and 3) purchases of zero coupon bonds and agency discount notes amounts presented as part of investing activities ( purchases of securities held-to-maturity ) were reported at par amount rather than the actual cash paid for the securities and the discounts on such securities were being presented as investing activities ( principal repayments and maturities of securities held-to-maturity ) rather than being excluded from the Cash Flow Statements.

The cash flows related to the accretion of discount on certain investment securities have been properly classified as cash flows from operating activities and the cash flows from the disposition of repossessed assets have been properly classified as cash flows from investing activities in the restated Consolidated Statement of Cash Flows for the nine month period ended September 30, 2004. The amounts presented as purchases, principal repayments and maturities of securities under cash flows from investing activities have also been corrected to reflect actual cash outflows and inflows related to zero coupon bonds and discounts notes. In addition, the Corporation has corrected the classification of other items, including items related to the 2004 restatement (see footnotes in table below), and the classification of short-term held-to-maturity investments (less than 90 days) from investments to cash and cash equivalents.

Also, the Corporation has corrected the classification of cash receipts from sales and repayments as well as cash disbursements in originations of loans classified as held-for-sale on the consolidated statements of cash flows. The Corporation previously reported the cash receipts from sales and repayments as well as cash disbursements in originations of loans classified as held-for-sale that were originally acquired for investment as cash flows of operating activities in the consolidated statements of cash flows. Since these loans were originally acquired by the Corporation for investment purposes, cash receipts from sales and repayments as well as cash disbursements in originations of these loans should be classified as cash flows of investing activities in the consolidated statements of cash flows.

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The following comparative table presents the effects of the aforementioned classification corrections as well as the impact of all restatement adjustments related with the 2004 restatement on the Consolidated Statement of Cash Flows for the nine month period ended September 30, 2004:

|  | 2004 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | As <br> Previously |  | Adjustments |  |  |  |
|  | Reported |  |  |  |  | (As |
| Nine Month Period Ended September 30, (in thousands) |  |  | Restated) |
| Cash flows from operating activities: |  |  |  |  |  |  |
| Net income | \$ | 129,220 |  |  | \$ | 6,411 | \$ | 135,631 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |  |  |  |
| Deferred income tax (benefit) provision (1) |  | $(5,047)$ |  | 5,285 |  | 238 |
| Unrealized derivatives (gain) (2) |  | $(1,174)$ |  | $(22,471)$ |  | $(23,645)$ |
| Amortization of brokers placement fees (2) |  |  |  | 10,229 |  | 10,229 |
| (Accretion) amortization of premiums and discounts on investment securities (3) |  |  |  | $(20,522)$ |  | $(20,522)$ |
| Decrease (increase) in other assets (3) |  | 6,011 |  | $(26,486)$ |  | $(20,475)$ |
| Other adjustments to cash flows from operating activities (4) (5) |  | $(7,526)$ |  | 52,428 |  | 44,902 |
| Total adjustments to reconcile net income to net cash provided by operating activities |  | $(7,736)$ |  | $(1,537)$ |  | $(9,273)$ |
| Net cash provided by operating activities |  | 121,484 |  | 4,874 |  | 126,358 |
| Cash flows from investing activities: |  |  |  |  |  |  |
| Proceeds from sale of repossessed assets (3) |  |  |  | 23,557 |  | 23,557 |
| Purchase of securities held to maturity (3) |  | $(5,182,605)$ |  | 3,635,533 |  | $(1,547,072)$ |
| Principal repayments and maturities of securities held to maturity (3) |  | 4,651,937 |  | $(3,595,004)$ |  | 1,056,933 |
| Other adjustments to cash flows from investing activities (4) (5) |  | $(1,894,906)$ |  | $(35,273)$ |  | $(1,930,179)$ |
| Net cash used in investing activities |  | $(2,425,574)$ |  | 28,813 |  | (2,396,761) |
| Cash flows from financing activities: |  |  |  |  |  |  |
| Net increase in deposits (2) |  | 590,289 |  | $(12,844)$ |  | 577,445 |
| Other adjustments to cash flows from financing activities (5) |  | 1,768,785 |  | $(1,417)$ |  | 1,767,368 |
| Net cash provided by financing activities |  | 2,359,074 |  | $(14,261)$ |  | 2,344,813 |
| Net increase in cash and cash equivalents |  | 54,984 |  | 19,426 |  | 74,410 |
| Cash and cash equivalents at beginning of period |  | 1,060,244 |  | $(8,136)$ |  | 1,052,108 |
| Cash and cash equivalents at end of period (6) | \$ | 1,115,228 | \$ | 11,290 | \$ | 1,126,518 |

(1) Deferred tax effect of items related to the 2004 restatement; refer to explanation of change in Note 1 Restatement of previously issued financial statements Income Taxes above.
(2) Refer to explanation of change in Note 1 Restatement of previously issued financial statements Accounting for Derivative Instruments and Broker Placement Fees above.
(3) Refer to explanation of change in the first paragraph of Restatement of 2004
Consolidated Statements of Cash Flows above.
(4) Refer to explanation of change in the third paragraph of Restatement of 2004
Consolidated
Statements of Cash Flows above.
(5) Change resulting from certain not significant 2004 restatement adjustments (refer to Note 1 Restatement of previously issued financial statements) and the correction of immaterial classification errors.
(6) Correction of classification of short-term held-to-maturity investments (less than 90 days) from investments to cash and cash equivalents.

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## 2 BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The Consolidated Financial Statements (unaudited) have been prepared in conformity with the accounting policies stated in the Corporation s Annual Audited Financial Statements included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2005. Certain information and note disclosure normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted from these statements pursuant to the rules and regulations of the SEC and, accordingly, these financial statements should be read in conjunction with the audited Consolidated Financial Statements of the Corporation for the year ended December 31, 2005, included in the Corporation s 2005 Annual Report on Form 10-K. All adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the statement of financial position, results of operations and cash flows for the interim periods have been reflected. All significant intercompany accounts and transactions have been eliminated in consolidation.

The results of operations for the quarter and nine month period ended on September 30, 2006, are not necessarily indicative of the results to be expected for the entire year.

On May 24, 2005, the Corporation s Board of Directors declared a two-for-one split in the Corporation s common stock. The record date of the stock split was June 15, 2005, and the distribution date was June 30, 2005. The per share data contained in the Consolidated Financial Statements prior to the quarter ended June 30, 2005 has been adjusted to reflect the two-for-one stock split.

## Recently issued accounting pronouncements

The Financial Accounting Standards Board ( FASB ), its Emerging Issues Task Force ( EITF ) and the SEC have issued the following accounting pronouncements and Issue discussions relevant to the Corporation s operations:

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115. This Statement allows entities to choose to measure certain financial assets and liabilities at fair value with changes in fair value reflected in earnings. The fair value option may be applied on an instrument-by-instrument basis. This Statement is effective for periods after November 15, 2007, however, early adoption is permitted provided that the entity also elects to apply the provisions of SFAS 157, Fair Value Measurements . The Corporation adopted SFAS 159 effective January 1, 2007. The Corporation decided to early adopt SFAS 159 for the callable brokered CDs and a portion of the callable fixed medium-term notes that were economically 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 determining to early adopt SFAS 159 for these instruments was to eliminate the operational procedures required by the long-haul method of accounting in terms of documentation, effectiveness assessment, and manual procedures followed by the Corporation to fulfill the requirements specified by SFAS 133.

Upon adoption of SFAS 159, the Corporation selected the fair value measurement for approximately $63 \%$, of the brokered CDs portfolio and certain of the medium-term notes portfolio ( designated liabilities ). Interest rate risk on the brokered CDs and medium term notes chosen for the fair value measurement option will continue to be economically hedged through callable interest rate swaps with the same terms and conditions. The cumulative after-tax effect on the opening balance of retained earnings from adopting these standards is an approximate increase of $\$ 92.2$ million. Under SFAS 159, this one-time credit was not recognized in current earnings. Regulatory capital increased by the positive adjustment to retained earnings, exceeding by higher margins the capital levels required to be classified as well-capitalized and strengthened the Corporation s regulatory capital ratios.

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With the Corporation s elimination of the use of the long-haul method in connection with the adoption of SFAS 159 as of January 1, 2007, the Corporation will no longer amortize the basis adjustment. The basis adjustment amortization is the reversal of the change in value of the 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 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 adoption adjustment to retained earnings, of all of the unamortized placement fees that were paid to broker counterparties upon the issuance of the brokered CDs and medium term notes. The Corporation previously amortized those fees through earnings based on the expected call date of the instruments. The impact of the de-recognition of the basis adjustment and the unamortized placement fees as of January 1, 2007 results in a cumulative after-tax reduction to retained earnings of approximately $\$ 23.8$ million. This negative charge is included in the total cumulative after-tax increase to retained earnings of $\$ 92.2$ million that results with the adoption of SFAS 157 and SFAS 159.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). This interpretation expresses the SEC staff $s$ views regarding the process of quantifying financial statement misstatements that could result in improper amounts of assets or liabilities. While a misstatement may not be considered material for the period in which it occurred, it may be considered material in a subsequent year if the corporation were to correct the misstatement through current period earnings. SAB 108 requires a materiality evaluation based on all relevant quantitative and qualitative factors and the quantification of the misstatement using both a balance sheet and income statement approach to determine materiality. SAB 108 is effective for periods ending after November 15, 2006. The adoption of this Statement did not have a material effect on the Corporation sfinancial condition and results of operations.

In September 2006, the FASB issued SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R) . This Statement requires corporations to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement is effective for periods ending after December 15, 2006. This Statement is not applicable to the Corporation and therefore has no impact to the Corporation s financial condition or results of operations.

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

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

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FIN 48, the Corporation elected to classify interest and penalties related to unrecognized tax portions as components of income tax expense.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140. This Statement requires that servicing assets and servicing liabilities be initially measured at fair value along with any derivative instruments used to mitigate inherent risks. This Statement is effective for periods beginning after September 15, 2006. The adoption of this Statement in 2007 did not have a material effect on the Corporation s financial condition and results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140 . This Statement allows fair value measurement for any hybrid financial instrument that contains an embedded derivative requiring bifurcation. It also establishes a requirement to evaluate interests in securitized financial assets to establish whether the interests are freestanding derivatives or hybrid financial instruments that contain an embedded derivative requiring bifurcation. This Statement is effective for all financial instruments acquired or issued after September 15, 2006. The adoption of this Statement did not have a material effect on the Corporation s financial condition and results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 . This Statement changes the requirements for the accounting for and reporting of a voluntary change in accounting principle. This Statement requires retrospective application to prior periods financial statements of a change in accounting principle unless it is impracticable to do so; in which case the earliest period for which retrospective application is practicable should be applied. If it is impracticable to calculate the cumulative effect of a change in accounting principle, the Statement requires prospective application as of the earliest date practicable. This Statement does not change the guidance in APB Opinion No. 20 with regard to the reporting of the correction of an error, or a change in accounting estimate. The Statement s purpose is to improve the comparability of financial information among periods. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005. The adoption of this statement did not have a material effect on the Corporation s financial condition and results of operations.

In December 2004, the Financial Accounting Standard Board ( FASB ) issued SFAS 123R, Share-Based Payment This statement is a revision of SFAS 123, Accounting for Stock- Based Compensation and it also supersedes APB No. 25, Accounting for Stock Issued to Employees, ( APB 25 ), and its related implementation guidance.

This Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). The cost will be recognized over the period during which an employee is required to provide service in exchange for the award the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service.

SFAS 123R eliminates the alternative to use APB 25 s intrinsic value method of accounting that was provided in SFAS 123 as originally issued. Under APB 25, issuing stock options to employees generally resulted in recognition of no compensation cost.

The Corporation prospectively applied SFAS123R to its financial statements as of January 1, 2006. Refer to Note 4 to these consolidated financial statements for required disclosures and further information on the impact of the adoption of this accounting pronouncement.

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## 3 EARNINGS PER COMMON SHARE

The calculations of earnings per common share for the quarters and nine month periods ended on September 30, 2006, 2005 and 2004 are as follows:

|  | $\begin{array}{c}\text { Quarter Ended } \\ \text { September 30, }\end{array}$ |  |  | $\begin{array}{c}\text { 2004 } \\ \text { (As }\end{array}$ |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Restated) |  |  |  |  |$)$

## Earnings per common share:

| Basic | $\$$ | 0.39 | $\$$ | 1.36 | $\$$ | 1.31 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Diluted | $\$$ | 0.39 | $\$$ | 1.32 | $\$$ | 1.27 |

Potential common shares consist of common stock issuable under the assumed exercise of stock options using the treasury stock method. This method assumes that the potential common shares are issued and the proceeds from exercise are used to purchase common stock at the exercise date. The difference between the number of potential shares issued and the shares purchased is added as incremental shares to the actual number of shares outstanding to compute diluted earnings per share. Stock options that result in lower potential shares issued than shares purchased under the treasury stock method are not included in the computation of dilutive earnings per share since their inclusion would have an antidilutive effect in earnings per share. For the quarter and nine month period ended September 30, 2006, there were $2,179,796$ and $2,438,791$ weighted-average outstanding stock options, respectively, that were excluded from the computation of outstanding shares because they were antidilutive. For

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the quarter and nine month period ended September 30, 2005, there were 1,719,600 and 725,228 weighted-average outstanding stock options, respectively, that were excluded from the computation of outstanding shares because they were antidilutive. All options outstanding were included in the computation of outstanding shares for the quarter ended September 30, 2004. For the nine month period ended on September 30, 2004, a total of 928,800 stock options, were not included in the computation of outstanding shares because they were antidilutive.

## 4 STOCK OPTION PLAN

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

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

During the second quarter of 2005, the Corporation issued 76,373 (152,746 as adjusted for the June 2005 stock split) shares of common stock as a result of the exercise of 36,479 stock options and 39,894 shares granted pursuant to stock appreciation rights before the June 2005 stock split, both under the Corporation s stock-based compensation plan.

Prior to the adoption of SFAS 123R on January 1, 2006, the Corporation accounted for stock options under the recognition and measurement principles of APB 25 and related Interpretations. No stock-based employee compensation cost was reflected in net income for the quarters and nine month periods ended September 30, 2005 and 2004, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. The table below illustrates the effect on net income and earnings per common share if the Corporation had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation granted during the third quarter and first nine months of 2005 and 2004.

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Pro-forma information:

|  | Quarter ended September 30, 2004 <br> (As |  |  | Nine mon Sep $2005$ <br> pt per share | ber <br> a) | ended <br> 2004 <br> (As <br> tated) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net income |  |  |  |  |  |  |
| As reported | \$ 17,305 | \$ | 88,393 | \$ 139,926 | \$ | 135,631 |
| Deduct: Stock-based employee compensation expense determined under fair value method |  |  |  | 6,118 |  | 4,963 |
| Pro forma | \$ 17,305 | \$ | 88,393 | \$ 133,808 | \$ | 130,668 |
| Earnings per common share-basic: |  |  |  |  |  |  |
| As reported | \$ 0.09 | \$ | 0.97 | \$ 1.36 | \$ | 1.31 |
| Pro forma | \$ 0.09 | \$ | 0.97 | \$ 1.28 | \$ | 1.25 |
| Earnings per common share-diluted: |  |  |  |  |  |  |
| As reported | \$ 0.09 | \$ | 0.94 | \$ 1.32 | \$ | 1.27 |
| Pro forma | \$ 0.09 | \$ | 0.94 | \$ 1.25 | \$ | 1.21 |

On January 1, 2006, the Corporation adopted SFAS 123R using the modified prospective method. Under this method, and since all previously issued stock options were fully vested at the time of the adoption, the Corporation expenses the fair value of all employee stock options granted after January 1, 2006 (same as the prospective method). The compensation expense associated with expensing stock options for the quarter and nine month period ended September 30, 2006 was approximately $\$ 0.5$ million and $\$ 5.4$ million, respectively. All employee stock options granted during 2006 were fully vested at the time of grant.

The activity of stock options during the first nine months of 2006 is set forth below:

Beginning of period
Options granted
Options exercised
Options expired unexercised

End of period outstanding and exercisable

Nine Month Period Ended
September 30, 2006
Weighted-Average
Remaining Aggregate
Contractual Intrinsic

| Number of | Weighted-Average | Term | Value <br> (In |
| :---: | ---: | :--- | :--- |
| Options | Exercise Price | (Years) | thousands) |
| $5,316,410$ | $\$$ | 13.28 |  |
| $1,235,000$ | 12.21 |  |  |
| $(2,379,000)$ | 8.30 |  |  |
| $(1,148,000)$ | 20.68 |  |  |
| $3,024,410$ | $\$$ | 13.95 | 7.23 |
| then |  |  | 2,065 |

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The fair value of options granted in 2006, 2005 and 2004 that was estimated using the Black-Scholes option pricing, and the assumptions used follow:

|  | $\mathbf{2 0 0 6}$ |  | $\mathbf{2 0 0 5}$ | $\mathbf{2 0 0 4}$ |
| :--- | ---: | ---: | ---: | ---: |
| Weighted Average Stock Price at grant date and |  |  |  |  |
| exercise price | $\$$ | 12.21 | $\$$ | 23.92 |
| Stock option estimated fair value | $\$ 2.89-\$ 4.60$ | $\$ 6.40-\$ 6.41$ | $\$ 5.30-\$ 5.45$ |  |
| Weighted-average estimated fair value | $\$$ | 4.36 | $\$$ | 6.40 |
| Expected stock option term (years) | $4.22-4.31$ | $4.25-4.27$ | $\$ .35$ |  |
| Expected volatility | $39 \%-46 \%$ | $28 \%$ | $4.08-4.33$ |  |
| Weighted-average expected volatility | $45 \%$ | $28 \%$ | $28 \%$ |  |
| Expected dividend yield | $2.2 \%-3.2 \%$ | $1.0 \%$ | $28 \%$ |  |
| Weighted-average expected dividend yield | $2.3 \%$ | $1.0 \%$ | $1.0 \%$ |  |
| Risk-free interest rate | $4.7 \%-5.6 \%$ | $4.2 \%$ | $1.0 \%$ |  |

The Corporation uses empirical research data to estimate options exercises and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. For 2006, the expected volatility is based on the historical implied volatility of the Corporation s common stock at each grant date. For periods prior to 2006, the expected volatility is based on the historical volatility of the Corporation s common stock over a 260 -working days period. The dividend yield is based on the historical 12-month dividend yield observable at each grant date. The risk-free rate for periods is based on historical zero coupon curves obtained from Bloomberg at the time of grant based on the option expected term.

No options were exercised during the third quarter of 2006 and 2005. The total intrinsic value of options exercised during the third quarter of 2004 was $\$ 1.1$ million. The total intrinsic value of options exercised during the first nine months of 2006, 2005 and 2004 was approximately $\$ 10.0$ million, $\$ 0.8$ million and $\$ 7.6$ million, respectively. Cash proceeds from options exercised during the third quarter of 2004 amounted to approximately $\$ 0.5$ million. Cash proceeds from options exercised during the first nine months of 2006, 2005 and 2004 amounted to approximately $\$ 19.8$ million, $\$ 0.6$ million and $\$ 3.2$ million, respectively.

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## 5 INVESTMENT SECURITIES

## Investment Securities Available for Sale

The amortized cost, gross unrealized gains and losses, approximate fair value, weighted-average yield and contractual maturities of investment securities available for sale at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004 were as follows:


Obligations of
U.S. Government

Sponsored
Agencies:


Puerto Rico
Government
Obligations:

| After 1 to 5 years | 4,624 | 149 |  | 4,773 | 6.17 | 4,594 | 223 |  | 4,817 | 6.17 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 5 to |  |  |  |  |  |  |  |  |  |  |
| 10 years | 15,467 | 303 | 507 | 15,263 | 4.86 | 15,271 | 196 | 678 | 14,789 | 4.84 |
| After 10 years | 5,360 | 101 | 172 | 5,289 | 5.88 | 5,311 | 131 | 42 | 5,400 | 5.88 |

United States
and Puerto Rico
Government
$\begin{array}{lllllllllll}\text { Obligations } & 440,813 & 582 & 10,504 & 430,891 & 4.42 & 419,115 & 550 & 5,009 & 414,656 & 4.34\end{array}$
Mortgage-backed
Securities:
FHLMC
certificates:

| Within 1 year | 10 |  |  | 10 | 6.06 | 2 |  |  | 2 | 4.26 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 1 to 5 years | 2,016 | 40 |  | 2,056 | 7.03 | 1,762 | 30 |  | 1,792 | 6.43 |
| After 5 to |  |  |  |  |  |  |  |  |  |  |
| 10 years |  |  |  |  |  | 1,336 | 82 |  | 1,418 | 7.98 |
| After 10 years | 6,021 | 55 | 156 | 5,920 | 5.60 | 6,839 | 77 | 166 | 6,750 | 5.55 |
|  |  |  |  |  |  |  |  |  |  |  |
|  | 8,047 | 95 | 156 | 7,986 | 5.96 | 9,939 | 189 | 166 | 9,962 | 6.03 |

GNMA
certificates:

| After 1 to 5 years | 692 | 5 |  | 697 | 6.37 | 939 | 14 | 953 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
|  | 1,068 | 6 | 3 | 1,071 | 5.78 | 291 | 10 | 301 |
|  | 6.39 |  |  |  |  |  |  |  |

After 5 to
10 years

| After 10 years | 393,906 | 482 | 7,663 | 386,725 | 5.23 | 438,565 | 1,021 | 1,959 | 437,627 | 5.19 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
|  | 395,666 | 493 | 7,666 | 388,493 | 5.24 | 439,795 | 1,045 | 1,959 | 438,881 | 5.20 |

FNMA
certificates:

| After 1 to 5 years | 105 |  |  | 105 | 7.33 | 187 | 3 |  | 190 | 7.55 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 5 to |  |  |  |  |  |  |  |  | 135 | 11.40 |
| 10 years | 9,026 | 11 | 150 | 8,887 | 4.76 | 124 | 11 |  | 10,031 | $1,029,149$ |
| After 10 years | 907,500 | 670 | 13,376 | 894,794 | 5.17 | $1,038,126$ | 1,054 | 10,14 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  | 916,631 | 681 | 13,526 | 903,786 | 5.16 | $1,038,437$ | 1,068 | 10,031 | $1,029,474$ | 5.14 |

Mortgage
pass-through
certificates:
$\begin{array}{lllllllll}\text { After } 10 \text { years } & 375 & 3 & 378 & 7.28 & 400 & 3 & 403 & 7.29\end{array}$
Mortgage-backed
$\begin{array}{lllllllllll}\text { Securities } & 1,320,719 & 1,272 & 21,348 & 1,300,643 & 5.19 & 1,488,571 & 2,305 & 12,156 & 1,478,720 & 5.16\end{array}$
Corporate
Bonds:

| After 1 to 5 years |  |  |  | 2,483 | 84 | 1 | 2,566 | 7.75 |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 5 to |  |  |  |  |  |  |  |  |  |
| 10 years | 1,302 | 792 | 1,124 | 7.46 | 1,912 | 12 | 42 | 1,882 | 8.09 |
| After 10 years | 4,468 |  |  |  | 7.72 | 21,857 | 909 | 1,833 | 20,933 |
|  |  |  |  |  |  |  |  |  |  |
| Corporate bonds | 5,770 | 970 | 4,800 | 7.66 | 26,252 | 1,005 | 1,876 | 25,381 | 7.52 |

Equity securities
(without contractual maturity)
$\begin{array}{lllll}18,302 & 1,955 & 37 & 20,220 & 0.80\end{array}$
$29,931 \quad 1,131 \quad 1,641 \quad 29,421 \quad 3.70$

Total Investment
Securities
Available for
Sale
\$ 1,785,604 \$3,809 \$ 32,859 \$ 1,756,554
4.96 \$ 1,963,869 \$4,991 \$20,682 \$ 1,948, 178
5.00

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September 30, 2004
(As Restated)
September 30, 2005
Gross
Weighted
Gross
Amortized Unrealized Fair average Amortized
cost gains losses value yield \% cost
Unrealized Fair average gains losses value yield \% (Dollars in thousands)
Obligations of
U.S. Government

Sponsored
Agencies:
After 5 to


Puerto Rico
Government
Obligations:

| After 1 to 5 years | 4,585 | 261 |  | 4,846 | 6.17 | 4,449 | 255 |  | 4,704 | 6.16 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 5 to |  |  |  |  |  |  |  |  |  |  |
| 10 years | 15,207 | 223 | 172 | 15,258 | 4.83 | 12,730 | 251 | 66 | 12,915 | 4.58 |
| After 10 years | 5,295 | 135 | 46 | 5,384 | 5.87 | 7,567 | 437 | 83 | 7,921 | 5.94 |
|  |  |  |  |  |  |  |  |  |  |  |
| United States <br> and Puerto Rico <br> Government |  |  |  |  |  |  |  |  |  |  |
| Obligations | 417,869 | 1,013 | 3,104 | 415,778 | 4.33 | 309,489 | 12,685 | 149 | 322,025 | 4.73 |

Mortgage-backed
Securities:
FHLMC
certificates:

| Within 1 year |  |  |  |  |  | 1 |  | 1 | 4.26 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| After 1 to 5 years | 1,964 | 45 |  | 2,009 | 6.41 | 2,634 | 135 | 2,769 | 6.35 |
| After 5 to |  |  |  |  |  |  |  |  |  |
| 10 years | 1,535 | 99 |  | 1,634 | 8.04 | 2,568 | 167 | 2,735 | 8.12 |
| After 10 years | 7,191 | 98 | 101 | 7,188 | 5.58 | 3,069 | 176 | 3,245 | 6.85 |
|  | 10,690 | 242 | 101 | 10,831 | 6.08 | 8,272 | 478 | 8,750 | 7.08 |

GNMA
certificates:

| After 1 to 5 years | 996 | 17 |  | 1,013 | 6.40 | 965 | 44 | 1,009 | 5.90 |
| :--- | ---: | ---: | :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| After 5 to |  |  |  |  |  |  |  |  |  |
| 10 years | 321 | 11 |  | 332 | 6.65 | 996 | 61 | 1,057 | 6.90 |
| After 10 years | 456,524 | 969 | 1,007 | 456,486 | 5.21 | 110,105 | 2,428 | 112,533 | 4.75 |
|  |  |  |  |  |  |  |  |  | 114,599 | 4.78

FNMA
certificates:

|  |  |  |  |  |  |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 1 to 5 years | 113 | 2 |  | 115 | 7.53 | 48 | 3 | 51 | 8.29 |  |
| After 5 to |  |  |  |  |  |  |  |  |  |  |
| 10 years | 164 | 8 |  | 172 | 9.10 | 362 | 34 |  | 396 | 8.37 |
| After 10 years | $1,093,553$ | 2,453 | 2,457 | $1,093,549$ | 5.11 | 922,291 | 16,546 | 3 | 938,834 | 4.97 |
|  | $1,093,830$ | 2,463 | 2,457 | $1,093,836$ | 5.11 | 922,701 | 16,583 | 3 | 939,281 | 4.98 |

Mortgage
pass-through
certificates:

| After 10 years | 408 | 4 |  | 412 | 7.29 | 554 | 5 |  | 559 | 7.28 |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Mortgage-backed |  |  |  |  |  |  |  |  |  |  |  |
| Securities | $1,562,769$ | 3,706 | 3,565 | $1,562,910$ | 5.15 | $1,043,593$ | 19,599 | 3 | $1,063,189$ | 4.97 |  |

Corporate
Bonds:

| Within 1 year | 20,000 |  |  | 20,000 | 4.68 | 20,000 | 450 | 20,450 | 6.36 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 1 to 5 years | 3,361 | 2,080 |  | 5,441 | 7.63 | 20,875 | 1,835 | 22,710 | 3.13 |
| After 5 to |  |  |  |  |  |  |  | 1,126 | 7.73 |
| 10 years | 3,399 | 1,022 | 87 | 4,334 | 7.81 | 375 | 751 |  |  |
| After 10 years | 22,682 | 914 | 1,490 | 22,106 | 7.44 |  |  | 44,286 | 4.74 |
| Corporate bonds | 49,442 | 4,016 | 1,577 | 51,881 | 6.36 | 41,250 | 3,036 |  |  |


| Equity securities |
| :--- |
| (without |


| contractual |
| :--- |
| maturity) |

Total Investment
Securities
Available for
Sale $\quad \$ 2,086,652 \quad \$ 15,241 \quad \$ 14,679 \quad \$ 2,087,214 \quad 4.97 \quad \$ 1,435,889 \quad \$ 44,138 \quad \$ 2,514 \quad \$ 1,477,513 \quad 4.78$ Maturities of mortgage-backed securities are based on contractual terms assuming no prepayments. Expected maturities of investments might differ from contractual maturities because they may be subject to prepayments and/or call options. The weighted average yield on investment securities held for sale is based on amortized cost and, therefore, does not give effect to changes in fair value. The net unrealized gains or losses on available for sale securities are presented as part of accumulated other comprehensive income.

The following tables show the Corporation s available-for-sale investments fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004:

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## Debt Securities

Obligations of U.S.
Government Sponsored Agencies
Puerto Rico Government Obligations
Mortgage-Backed
Securities

| FHLMC | 591 |  | 4,008 | 156 | 4,599 | 156 |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| GNMA | 367,308 | 7,666 |  |  | 367,308 | 7,666 |  |
| FNMA | 368,958 | 5,900 | 506,296 | 7,626 | 875,254 | 13,526 |  |
| Corporate Bonds |  |  | 4,800 | 970 | 4,800 | 970 |  |
| Equity Securities | 1,735 |  | 37 |  |  | 1,735 | 37 |
|  | $\$ 751,503$ | $\$ 13,668$ | $\$ 912,246$ | $\$ 19,191$ | $\$ 1,663,749$ | $\$ 32,859$ |  |

As of December 31, 2005
Less than 12 months Unrealized

12 months or more Unrealized
Fair
Fair Value Losses
Debt Securities
Obligations of U.S.
Government Sponsored
Agencies
Puerto Rico Government Obligations
Mortgage-Backed
Securities

| FHLMC | 4,440 | 166 |  |  | 4,440 | 166 |
| :--- | ---: | ---: | :--- | ---: | ---: | ---: |
| GNMA | 369,231 | 1,959 |  | 369,231 | 1,959 |  |
| FNMA | 939,197 | 10,031 |  |  | 939,197 | 10,031 |
| Corporate Bonds | 8,711 | 1,876 |  | 8,711 | 1,876 |  |
| Equity Securities | 16,229 | 1,641 |  |  |  | 16,229 |

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The Corporation s investment securities portfolio is comprised principally of (i) mortgage-backed securities issued or guaranteed by FNMA, GNMA or FHLMC and (ii) U.S. Treasury and agencies securities. Thus, payment of a substantial portion of these instruments is either guaranteed or secured by mortgages together with a U.S. government sponsored entity or is backed by the full faith and credit of the U.S. government. Principal and interest on these securities are therefore deemed recoverable. The Corporation s policy is to review its investment portfolio for possible other-than temporary impairment, at least quarterly. At September 30, 2006, management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments; as a result, the impairments are considered temporary. The increase in the net unrealized
loss position during 2006 was principally due to increases in interest rates and the corresponding decrease in prices.
During the first nine months of 2006, 2005, and 2004, the Corporation recorded other-than-temporary impairments of $\$ 12.1$ million, $\$ 1.5$ million, and $\$ 2.7$ million, respectively, on certain equity securities held in its investment portfolio. Management concluded that the declines in value of the securities were other-than-temporary; as such, the cost basis of these securities was written down to the market value at the date of the analyses.

Total proceeds from the sale of securities available for sale during the nine-month period ended September 30, 2006 amounted to approximately $\$ 228.1$ million ( $2005 \quad \$ 223.3$ million ; 2004- $\$ 32.8$ million). The Corporation realized gross gains of approximately $\$ 5.6$ million and approximately $\$ 0.2$ million in gross realized losses for the first nine months of 2006 (2005 $\$ 14.3$ million in gross realized gains; 2004- $\$ 7.6$ million in gross realized gains and approximately $\$ 15,000$ in gross realized losses).

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## Investment Securities Held to Maturity

The amortized cost, gross unrealized gains and losses, approximate fair value, weighted-average yield and contractual maturities of investment securities held-to-maturity at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004 were as follows:

|  | $\begin{array}{c}\text { September 30, } 2006 \\ \text { Gross }\end{array}$ |  | December 31, 2005 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Gross |  |  |  |$]$| Weighted |
| :---: |

U.S. Treasury

Securities:
Due within
$\begin{array}{llllllllllllllll}1 \text { year } & \$ & 156,913 & \$ & 23 & \$ & \$ & 156,936 & 4.96 & \$ & 149,156 & \$ & 48 & \$ & & \$\end{array}$

Obligations of other U.S.
Government
Sponsored
Agencies:
$\begin{array}{llllllllll}\text { After } 10 \text { years } & 2,066,418 & 63,531 & 2,002,887 & 5.83 & 2,041,558 & 65,799 & 1,975,759 & 5.83\end{array}$
Puerto Rico
Government
Obligations:

| After 1 to 5 years |  |  |  |  |  | 5,000 | 20 |  | 5,020 | 5.00 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| After 5 to |  |  |  |  |  |  |  |  |  |  |
| 10 years | 16,575 | 535 | 141 | 16,969 | 5.84 |  |  |  |  |  |
| After 10 years | 15,000 | 309 |  | 15,309 | 5.50 | 9,163 | 502 | 143 | 9,522 | 5.94 |

United States
and Puerto Rico
Government
$\begin{array}{lllllllllll}\text { obligations } & 2,254,906 & 867 & 63,672 & 2,192,101 & 5.77 & 2,204,877 & 570 & 65,942 & 2,139,505 & 5.70\end{array}$

Mortgage-backed
securities:
FHLMC
certificates:
After 5 to
$\begin{array}{lllllllll}10 & \text { years } & 16,511 & 574 & 15,937 & 3.57 & 20,211 & 778 & 19,433\end{array}$
FNMA
certificates:
After 5 to

| 10 years | 15,196 |  | 542 | 14,654 | 3.80 | 18,418 | 602 | 17,816 | 3.79 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 10 years | $1,069,417$ | 57 | 37,369 | $1,032,105$ | 4.38 | $1,195,082$ | 35,277 | $1,159,805$ | 4.32 |
|  | $1,101,124$ | 57 | 38,485 | $1,062,696$ | 4.36 | $1,233,711$ | 36,657 | $1,197,054$ | 4.30 |

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Mortgage-backed
securities

Corporate
Bonds:

| After 10 years | 2,000 | 2,000 | 5.80 |
| :--- | :--- | :--- | :--- |

Total Investment
Securities Held
to Maturity $\quad \$ 3,358,030 \quad \$ 924 \quad \$ 102,157 \quad \$ 3,256,797 \quad 5.31 \quad \$ 3,438,588 \quad \$ 570 \quad \$ 102,599 \quad \$ 3,336,559 \quad 5.20$

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Obligations of other U.S.
Government
Sponsored
Agencies:
Due within

| 1 year | \$ | 64,838 | \$ | \$ | \$ | 64,838 | 3.85 | \$ | \$ |  | \$ | \$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| fter 10 years |  | ,583,502 |  |  |  | 1,538,795 | 76 |  |  | 3 | 39,122 | 1,972,377 | 5.3 |

Puerto Rico
Government
Obligations:

| After 1 to 5 years | 5,000 | 43 |  | 5,043 | 5.00 | 5,000 | 135 | 5,135 | 5.00 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 10 years | 9,030 | 507 | 144 | 9,393 | 5.94 | 8,517 | 797 | 9,314 | 5.93 |

United States and Puerto Rico
Government $\begin{array}{llllllllll}\text { obligations } & 1,662,370 & 550 & 44,851 & 1,618,069 & 5.68 & 2,024,657 & 1,291 & 39,122 & 1,986,826\end{array} 5.39$

Mortgage-backed
securities:
FHLMC
certificates:
After 5 to

| 10 years | 21,736 | 743 | 20,993 | 3.69 | 28,508 | 5 | 624 | 27,889 | 3.59 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

FNMA
certificates:
After 5 to

| 10 years | 19,611 | 539 | 19,072 | 3.78 | 24,905 |  | 46 | 24,859 | 3.80 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| After 10 years | $1,263,032$ | 27,895 | $1,235,137$ | 4.29 | $1,572,601$ | 32 | 10,154 | $1,562,479$ | 4.27 |

Mortgage-backed

| securities | $1,304,379$ | 29,177 | $1,275,202$ | 4.27 | $1,626,014$ | 37 | 10,824 | $1,615,227$ | 4.25 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Total Investment
Securities Held to Maturity $\quad \$ 2,966,749 \quad \$ 550 \quad \$ 74,028 \quad \$ 2,893,271 \quad 5.06 \quad \$ 3,650,671 \quad \$ 1,328 \quad \$ 49,946 \quad \$ 3,602,053 \quad 4.89$

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

The following tables show the Corporation s held-to-maturity investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004.


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Held-to-maturity securities in an unrealized loss position at September 30, 2006 are primarily mortgage-backed securities and U.S. agency securities. The vast majority of them are rated the equivalent of AAA by the major rating agencies. Management believes that the unrealized losses in the held-to-maturity portfolio at September 30, 2006 are substantially related to market interest rate fluctuations and not deterioration in the creditworthiness of the issuers; as a result, the impairment is considered temporary.

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## 6 OTHER EQUITY SECURITIES

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

At September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004, there were investments in FHLB stock with book value of $\$ 19.3$ million, $\$ 40.9$ million, $\$ 75.8$ million and $\$ 68.6$ million respectively. The estimated market value of such investments is its redemption value determined by the ultimate recoverability of its par value.

The Corporation has other equity securities that do not have a readily available fair value. The carrying value of such securities at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004 was $\$ 1.7$ million, $\$ 1.4$ million, $\$ 1.4$ million and $\$ 0.4$ million, respectively.

## 7 LOAN PORTFOLIO

The following is a detail of the loan portfolio:


The Corporation s primary lending area is Puerto Rico. The Corporation s Bank subsidiary also lends in the U.S. and British Virgin Islands markets and in the state of Florida (USA). The Corporation has a significant lending concentration of $\$ 527.8$ million in one mortgage originator in Puerto Rico at September 30, 2006. The Corporation has outstanding $\$ 433.2$ million with another mortgage originator in Puerto Rico for total loans granted to mortgage originators amounting to $\$ 961.0$ million at September 30, 2006. These commercial loans were secured by individual residential and commercial mortgage loans. The mortgage originators have always paid the loans in accordance with their terms and conditions of the loan agreements.

Of the total net loans portfolio of $\$ 10.7$ billion as of September 30, 2006, approximately $77 \%$ have credit risk concentration in Puerto Rico, $15 \%$ in the state of Florida and $8 \%$ in the Virgin Islands.

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On May 25, 2006, the Corporation entered into a series of credit agreements with Doral Financial Corporation ( Doral ) to formally document as secured borrowings the loan transfers between the parties that previously had been accounted for 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 incurs as part of the sales of the mortgages that 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 will be reduced proportionately to the extent that Doral does not sell the mortgages. As a result of the sharing agreement and the partial extinguishment of the commercial loans by Doral, the Corporation recorded a net loss of $\$ 10.6$ million during the first nine months of 2006 composed of gains and losses as part of the sharing agreement and the difference between the carrying value of the loans and the net payment received from Doral.

## 8 ALLOWANCE FOR LOAN AND LEASE LOSSES

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

|  | Quarter Ended <br> September 30, |  |  |  |
| :--- | :---: | :---: | :---: | :---: |
|  | $\mathbf{2 0 0 6}$ | $\mathbf{2 0 0 5}$ | $\mathbf{2 0 0 4}$ |  |
| Balance at beginning of period | (Dollars in thousands) |  |  |  |
| Brovision for loan and lease losses | $\$ 146,527$ | $\$ 146,154$ | $\$ 133,678$ |  |
| Charge-offs | 20,560 | 12,861 | 13,200 |  |
| Recoveries | $(21,233)$ | $(13,197)$ | $(11,104)$ |  |
|  | 5,071 | 1,449 | 1,479 |  |
| Balance at end of year |  |  |  | $\$ 147,267$ |


|  | Nine Month Period Ended September 30, |  |  |
| :---: | :---: | :---: | :---: |
|  | 2006 | 2005 | 2004 |
|  | (Dollars in thousands) |  |  |
| Balance at beginning of period | \$ 147,999 | \$ 141,036 | \$ 126,378 |
| Provision for loan and lease losses | 49,290 | 34,890 | 39,600 |
| Charge-offs | $(54,494)$ | $(34,794)$ | $(33,081)$ |
| Recoveries | 8,130 | 4,772 | 4,356 |
| Other adjustments (1) |  | 1,363 |  |
| Balance at end of year | \$ 150,925 | \$ 147,267 | \$ 137,253 |

[^0]of Ponce
General
Corporation.

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The allowance for impaired loans is part of the allowance for loan and lease losses. These loans represent loans for which management has determined that it is probable that the debtor will be unable to pay all the amounts due, according to the contractual terms of the loan agreement, and do not necessarily represent loans for which the Corporation will incur a substantial loss. At September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004, impaired loans had a related allowance as follows:

|  |  |  |  | As of September |
| :---: | :---: | :---: | :---: | :---: |
|  | As of September | As of December | As of September | 30, |
|  | 30, | 31, | 30, | $\begin{gathered} 2004 \\ (\mathrm{As} \end{gathered}$ |
|  | 2006 | 2005 | 2005 | Restated) |
|  | (Dollars in thousands) |  |  |  |
| Impaired loans | \$60,159 | \$ 59,801 | \$ 58,369 | \$ 62,589 |
| Allowance for impaired loans | \$ 8,762 | \$ 9,219 | \$ 17,193 | \$ 14,729 |

Interest income in the amount of approximately $\$ 0.6$ million, $\$ 1.1$ million and $\$ 0.4$ million was recognized on impaired loans for the quarters ended September 30, 2006, 2005 and 2004, respectively. Interest income in the amount of approximately $\$ 2.6$ million, $\$ 3.8$ million and $\$ 1.6$ million was recognized on impaired loans for the nine month period ended September 30, 2006, 2005 and 2004, respectively.

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## 9 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

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

## Interest rate swap contracts that qualify for hedge accounting

As part of the interest rate risk management, the Corporation has entered into a series of interest rate swap agreements. Under the interest rate swaps, the Corporation agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Net interest settlements on interest rate swaps that qualify for hedge accounting and unrealized gains and losses arising from changes in fair value of derivative instruments and hedged items are recorded as an adjustment to interest income or interest expense depending on whether an asset or liability is being hedged.

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 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 that changes in the fair values of a derivative do not offset changes in the fair values of the hedged item due to changes in the hedged risk in the Consolidated Statement of Income.

First BanCorp s implementation of the long-haul method resulted from its previously reported determination that it should not have used the short-cut method to account for interest rate swaps related to brokered CDs and mediumterm notes because of technical issues involving the interpretation of the use of the method (refer to First BanCorp audited Consolidated Financial Statements, included in the Corporation s amended 2004 Annual Report on Form 10-K for additional information). Accordingly, prior to the implementation of the long-haul method, First BanCorp had reflected changes in the fair value of those swaps as well as swaps related to certain loans as non-hedging instruments through operations. Prior to the implementation of fair value hedge, the Corporation recorded unrealized losses in the valuation of derivative instruments of approximately $\$ 68.0$ million for 2006 . With respect to the brokered CDs and medium term notes ( hedged liabilities ) the basis differential between the market value and the book value of the hedged liabilities at the inception of fair value hedge accounting in the amount of approximately $\$ 200.0$ million amortizes or accretes as a yield adjustment over the expected remaining term of the hedged liabilities as the changes in value since the inception of the long haul method are recorded to the hedged liabilities. For the third quarter and first nine months of 2006, the Corporation recorded an accretion of $\$ 0.8$ million and an amortization of $\$ 0.5$ million, respectively, as a basis adjustment on the hedged liabilities.

The Corporation recognized, as a reduction to interest expense, approximately $\$ 1.4$ million and $\$ 3.4$ million for the quarter and nine-months ended September 30, 2006, respectively, representing ineffectiveness on the hedges of its brokered CDs and medium-term notes that qualified as fair value hedges under SFAS 133.

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## Interest rate swap contracts not qualifying for hedge accounting

Prior to April 3, 2006, the Corporation used interest rate swaps as economic hedges. These swaps either did not qualify for hedge accounting treatment or were not qualified by the Corporation for hedge accounting treatment. Changes in the fair value of these derivatives and the interest exchanged were recognized in earnings in the interest income or interest expense caption of the Consolidated Statements of Income depending upon whether an asset or liability was being economically hedged. At December 31, 2005, September 30, 2005 and September 30, 2004, all derivative instruments held by the Corporation were considered economic hedges as these did not qualify for hedge accounting under SFAS 133.

The following table summarizes the notional amounts of all derivative instruments as of September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004:

## Notional amounts

|  | Notional amounts |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { As of } \\ \text { September } \\ \text { 30, } \end{gathered}$ | As of December 31, |  | As of September 30 |  | As of September 30, |  |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  | $\begin{gathered} 2004 \\ (\mathrm{As} \end{gathered}$ |
|  | 2006 |  | 2005 |  | 2005 |  | Restated) |
|  | (Dollars in thousands) |  |  |  |  |  |  |
| Interest rate swap agreements: |  |  |  |  |  |  |  |
| Pay fixed versus receive floating | \$ 80,720 | \$ | 109,320 | \$ | 109,320 | \$ | 113,165 |
| Received fixed versus pay floating | 4,858,490 |  | 5,751,128 |  | 5,748,120 |  | 3,867,766 |
| Embedded written options | 13,515 |  | 13,515 |  | 13,515 |  | 13,515 |
| Purchased options | 13,515 |  | 13,515 |  | 13,515 |  | 13,515 |
| Written interest rate cap agreements | 125,200 |  | 150,200 |  | 150,200 |  | 25,000 |
| Purchased interest rate caps | 338,617 |  | 386,750 |  | 556,052 |  | 25,000 |
|  | \$ 5,430,057 | \$ | 6,424,428 |  | 6,590,722 |  | 4,057,961 |

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The following table summarizes the notional amounts of all derivatives by the Corporation s designation as of September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004:

## Notional amounts



As of September 30, 2006, derivatives qualifying for fair value hedge accounting with a negative fair value of $\$ 143.8$ million were recorded as part of Accounts payable and other liabilities in the Consolidated Statements of Financial Condition. Changes in the fair value of hedged liabilities since the inception of hedge accounting were recorded to the hedged liabilities.

As of September 30, 2006, derivatives not designated or not qualifying as a hedge with a positive fair value of $\$ 16.5$ million (December 31, $2005 \quad \$ 15.8$ million; September 30, $2005 \quad \$ 17.6$ million; September 30, 2004 $\$ 5.8$ million) and with a negative fair value of $\$ 19.6$ million (December 31, $2005 \quad \$ 158.1$ million; September 30, 2005
$\$ 126.2$ million; September 30, 2004 - $\$ 58.8$ million) were recorded as part of Other Assets and Accounts payable and other liabilities , respectively, in the Consolidated Statements of Financial Condition.

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The majority of the Corporation s derivative instruments represent interest rate swaps and mainly convert long-term fixed-rate brokered CDs to a floating rate. A summary of the types of swaps used at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004 follows:

| As of <br> September 30, <br> $\mathbf{2 0 0 6}$ | As of <br> December 31, <br> $\mathbf{2 0 0 5}$ <br> (Dollars in thousands) | As of <br> September 30, <br> 2005 | As of <br> September 30, <br> 2004 |
| :---: | :---: | :---: | :---: |
| (As Restated) |  |  |  |

Floating rates range from 5 basis points under to 19.5 basis points over 3-month LIBOR

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

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

To satisfy the needs of its customers, the Corporation may enter into non-hedging transactions. These transactions are structured with the same terms and conditions and the Corporation participates as a buyer in one of the agreements and as the seller in the other agreements.

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

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## 10 GOODWILL AND OTHER INTANGIBLES

Goodwill at September 30, 2006 amounted to $\$ 28.7$ million (December 31, $2005 \$ 28.7$ million, September 30, $2005 \$ 28.7$ million and September 30, $2004 \$ 0$ ) and resulted primarily from the acquisition of Ponce General Corporation in 2005. No goodwill was written down during 2006, 2005 and 2004.

At September 30, 2006, the gross carrying amount and accumulated amortization of core deposit intangibles was $\$ 41.2$ million and $\$ 14.1$ million, respectively, recognized as part of Other Assets in the Consolidated Statements of Financial Condition (December 31, $2005 \quad \$ 41.2$ million and $\$ 11.6$ million, respectively ; September 30, 2005 $\$ 41.2$ million and $\$ 10.3$ million, respectively ; September 30, $2004 \quad \$ 23.9$ million and $\$ 7.3$ million, respectively). During the quarters ended September 30, 2006, 2005 and 2004, the amortization expense of core deposits amounted to $\$ 0.8$ million, $\$ 0.9$ million, and $\$ 0.6$ million, respectively. For the nine month periods ended September 30, 2006, 2005 and 2004, the amortization expense of core deposits amounted to $\$ 2.6$ million, $\$ 2.5$ million, and $\$ 1.8$ million, respectively.

## 11 DEPOSITS

The following table summarizes deposit balances:

|  | As of September 30, | As of December 31, |  | As of September 30, |  | As of September 30, <br> 2004 <br> (As <br> Restated) |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
|  | 2006 |  | 2005 |  | 2005 |  |  |
|  | (Dollars in thousands) |  |  |  |  |  |  |
| Non-interest-bearing checking account <br> deposits $\$$ 676,028 $\$$ 811,006 $\$$ 751,690 $\$$ 603,713 |  |  |  |  |  |  |  |
| Saving accounts | 998,844 |  | 1,034,047 |  | 1,084,843 |  | 893,080 |
| Interest-bearing checking accounts | 354,604 |  | 375,305 |  | 376,915 |  | 331,117 |
| Certificates of deposit | 1,703,483 |  | 1,664,379 |  | 1,667,130 |  | 1,336,161 |
| Brokered certificates of deposit | 8,148,566 |  | 8,579,015 |  | 8,372,226 |  | 4,193,475 |
|  | \$ 11,881,525 |  | 12,463,752 | \$ | 12,252,804 |  | 7,357,546 |

The interest expense on deposits includes the valuation to market of interest rate swaps that hedge brokered certificates of deposit, the related interest exchanged, the amortization of broker placement fees and the basis adjustment amortization on the brokered CDs designated under fair value hedges.

The following are the components of interest expense on deposits:

\left.|  | Quarter ended |  |  | Nine month period ended |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| September |  |  |  |  |  |  |$\right)$

Interest expense on deposits excluding unrealized (gain) loss on derivatives
(designated and undesignated hedges) and (accretion) amortization of basis adjustment on fair value hedges
Unrealized (gain) los on derivatives (designated and undesignated hedges) (Accretion) amortization of basis adjustment on fair value hedges 148,394 93,485 33,426

418,152
214,269
92,619

Total interest expense $\begin{array}{lllllllllll}\text { on deposits } & \$ 135,647 & \$ & 161,153 & \$ & (30,654) & \$ 479,639 & \$ & 252,841 & \$ & 71,913\end{array}$

Total interest expense on deposits includes interest exchanged on interest rate swaps that hedge designated and undesignated brokered certificates of deposit that for the quarter and nine month period ended September 30, 2006 amounted to net interest incurred of $\$ 6.0$ million and $\$ 4.3$ million, respectively (2005 net interest realized for the quarter and nine month period of $\$ 16.4$ million and $\$ 61.5$ million, respectively; 2004 net interest realized for the quarter and nine month period of $\$ 32.7$ million and $\$ 94.7$ million, respectively).

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## 12 NOTES PAYABLE

Notes payable consist of:
$\left.\begin{array}{lccccc} & & & \text { September } \\ \text { 30, }\end{array}\right)$

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## 13 OTHER BORROWINGS

Other borrowings consist of:

|  |  |  | September <br> 30, |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
|  | September <br> 30, | 3ecember <br> 31, | September <br> 30, | 2004 <br> (As |
| Restated) |  |  |  |  |

## 14 SUBORDINATED NOTES

On December 20, 1995, the Corporation issued $7.63 \%$ subordinated capital notes in the amount of $\$ 100$ million maturing on December 20, 2005. The notes were issued at a discount. At September 30, 2006, there was no outstanding balance as the notes payable were paid at their maturity date of December 20, 2005 (carrying value of $\$ 82.7$ million as of September 30, 2005 and $\$ 82.1$ million as of September 30, 2004). Interest on the notes was paid semiannually and at maturity. The notes represented unsecured obligations of the Corporation ranking subordinate in right of payment to all existing and future senior debt including the claims of depositors and other general creditors. The notes could not be redeemed prior to their maturity.

## 15 INCOME TAXES

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

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. The additional tax related to the income earned from January 1 to the date of enactment of the law was

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fully recorded in the third quarter of 2005. On May 13, 2006, with an effective date of January 1, 2006, the Governor of Puerto Rico approved an additional transitory tax rate of $2.0 \%$ applicable only to companies covered by the Puerto Rico Banking Act as amended, such as First Bank Puerto Rico ( First Bank or the Bank ), which raised the maximum statutory tax rate to $43.5 \%$ for taxable years that commenced during calendar year 2006. For taxable years beginning after December 31, 2006, the maximum statutory tax rate will be $39 \%$. The PR Code also includes an alternative minimum tax of $22 \%$ that applies if the Corporation $s$ regular income tax liability is less than the alternative minimum tax requirements.

The Corporation has maintained an effective tax rate lower than the maximum statutory rate mainly by investing in government obligations and mortgage-backed securities exempt from U.S. and Puerto Rico income taxes and doing business through international banking units (IBEs) of the Corporation and the Bank and by the Bank s subsidiary, FirstBank Overseas Corporation. 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; such limitations were $30 \%$ of total net taxable income for a taxable year commencing between July 1, 2004 and July 1, 2005 , and $20 \%$ of total net taxable income for taxable years commencing thereafter.

For the nine month period ended September 30, 2006, the Corporation s provision for income tax was $\$ 14.8$ million compared to $\$ 32.0$ million and $\$ 39.8$ million for the same period in 2005 and 2004, respectively. The decrease in income tax expense for the first nine months of 2006 as compared to the first nine months of 2005 and 2004 was mainly due to an increase in deferred tax benefits resulting principally from higher unrealized losses on derivative instruments. For the first nine months of 2006, the Corporation recognized a deferred tax benefit of $\$ 35.6$ million compared to a deferred tax benefit of $\$ 17.9$ million for the same period in 2005 and a deferred tax provision of $\$ 0.2$ million for the first nine months of 2004.

The Corporation evaluated its ability to realize its deferred tax assets and concluded, based on the evidence available, 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 $\$ 4.9$ million as of September 30, 2006. At September 30, 2006, the deferred tax asset, net of the valuation allowance, amounted to approximately $\$ 170.9$ million compared to $\$ 93.3$ million at September 30, 2005 and $\$ 55.6$ million at September 30, 2004. At September 30, 2005 and 2004, based on the Corporation $s$ analysis and available evidence, the Corporation did not establish a valuation allowance.

## 16 SEGMENT INFORMATION

Based upon the Corporation s organizational structure and the information provided to the Chief Operating Decision Maker and to a lesser extent to the Board of Directors, the operating segments are driven primarily by the Corporation s legal entities. At September 30, 2006, 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.

The Commercial and Corporate Banking segment consists of the Corporation s lending and other services for large customers represented by the public sector and specialized and middle-market clients. The Commercial and Corporate Banking segment offers commercial loans, including commercial real estate and construction loans, and other products such as cash management and business management services. The Mortgage Banking segment s

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

The accounting policies of the business segments are the same as those described in Note 1 of the Corporation s financial statements for the year ended December 31, 2005 contained in the annual report of the Corporation on Form $10-\mathrm{K}$.

The Corporation evaluates the performance of the segments based on net interest income after the estimated provision for loan and lease losses, non-interest income and direct non-interest expenses. The segments are also evaluated based on the average volume of their interest-earning assets less the allowance for loan and lease losses.

The following table presents information about the reportable segments (in thousands):


## For the quarter ended

September 30, 2005:

| Interest income | \$ | 27,821 | \$ | 45,326 | \$ | 117,823 | \$ | 77,586 | \$ | 23,707 | \$ | 292,263 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net (charge) credit for transfer of funds |  | $(17,677)$ |  | 20,522 |  | $(69,692)$ |  | 70,260 |  | $(3,413)$ |  |  |
| Interest expense |  |  |  | $(14,317)$ |  |  |  | $(207,383)$ |  | $(3,820)$ |  | $(225,520)$ |
| Net interest income (loss) |  | 10,144 |  | 51,531 |  | 48,131 |  | $(59,537)$ |  | 16,474 |  | 66,743 |
| Provision for loan and lease losses |  | (470) |  | $(7,295)$ |  | $(1,859)$ |  |  |  | $(3,237)$ |  | $(12,861)$ |
| Other income |  | 16 |  | 7,098 |  | 1,202 |  | 4,727 |  | 4,650 |  | 17,693 |
| Direct operating expenses |  | $(4,023)$ |  | $(20,003)$ |  | $(2,651)$ |  | $(1,432)$ |  | $(9,242)$ |  | $(37,351)$ |
| Segment income | \$ | 5,667 | \$ | 31,331 | \$ | 44,823 | \$ | $(56,242)$ | \$ | 8,645 | \$ | 34,224 |

Average earnings assets
\$1,702,626 \$1,769,130
\$7,561,035 \$6,471,610 \$ 917,143 \$18,421,544
For the quarter ended
September 30, 2004 (As
Restated):
$\left.\left.\begin{array}{lcccccccccc}\text { Interest income } & \$ & 19,539 & \$ & 34,492 & \$ & 49,082 & \$ & 71,516 & \$ & 12,035\end{array}\right) \$ 186,664\right)$

Average earnings assets \$1,152,374 $\$ 1,352,992 \quad \$ 5,258,914 \quad \$ 5,808,739 \quad \$ 296,362 \quad \$ 13,869,381$

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Average earnings assets \$1,530,763 \$1,657,212 \$7,172,343 \$5,823,033 \$ 710,506 \$16,893,857

For the nine-month period ended
September 30, 2004 (As Restated):
$\left.\left.\begin{array}{lcccccccccc}\text { Interest income } & \$ & 56,217 & \$ & 101,011 & \$ & 134,058 & \$ & 172,292 & \$ & 34,505\end{array}\right) \$ 498,083\right)$

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The following table presents a reconciliation of the reportable segment financial information to the consolidated totals (in thousands):

|  | Quarter Ended <br> September 30, |  |  |  | 2004 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| (As Restated) |  |  |  |  |  |

## Average assets:

| Total average earning assets for segments | $\$ 18,430,107$ | $\$ 18,421,544$ | $\$ 13,869,381$ |
| :--- | ---: | ---: | ---: |
| Average non- earning assets | 736,097 | 588,549 | 409,889 |
| Total consolidated average assets | $\$ 19,166,204$ | $\$ 19,010,093$ | $\$ 14,279,270$ |


|  | Nine-month Period Ended September 30, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2006 |  | 2005 |  | 2004 <br> (As Restated) |  |
| Net income: |  |  |  |  |  |  |
| Total income for segments and other | \$ | 165,823 | \$ | 239,376 | \$ | 232,182 |
| Other operating expenses |  | $(88,656)$ |  | $(67,448)$ |  | $(56,796)$ |
| Income before income taxes |  | 77,167 |  | 171,928 |  | 175,386 |
| Income taxes |  | $(14,819)$ |  | $(32,002)$ |  | $(39,755)$ |
| Total consolidated net income | \$ | 62,348 | \$ | 139,926 | \$ | 135,631 |

## Average assets:

| Total average earning assets for segments | $\$ 19,147,451$ | $\$ 16,893,857$ | $\$ 12,825,120$ |
| :--- | ---: | ---: | ---: | ---: |
| Average non-earning assets | 721,444 | 537,922 | 446,754 |
| Total consolidated average assets | $\$ 19,868,895$ | $\$ 17,431,779$ | $\$ 13,271,874$ |

## 17. COMMITMENTS AND CONTINGENCIES

The Corporation enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments may include commitments to extend credit and commitments to sell and purchase mortgage loans at fair value. As of September 30, 2006, commitments to extend credit amounted to approximately $\$ 1.9$ billion and stand by letters of credit amounted to approximately
$\$ 100.8$ million. Commitments to extend credit are agreements to lend to a customer as long as the conditions established in the contract are met. Commitments generally have fixed expiration dates or other termination clauses. Generally, the Corporation s mortgage banking activities do not enter into interest rate lock agreements with its prospective borrowers.

As of September 30, 2006, First BanCorp and its subsidiaries were defendants in various legal proceedings arising in the ordinary course of business. Management believes, based on the opinion of legal counsel, that the final disposition of these matters will not have a material adverse effect on the Corporation $s$ financial position or results of operations, except as described below.

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On August 1, 2005, the Audit Committee of the Corporation determined that it should review the background and accounting for certain mortgage-related transactions that the Corporation had entered into with Doral Financial Corporation ( Doral ) and R\&G Financial Corporation ( R\&G ) between 1999 and 2005 that did not qualify as true sales for accounting purposes. The Committee retained the law firms of Clifford Chance U.S. LLP and Martínez Odell \& Calabria and forensic accountants FTI Consulting Inc. to assist the Audit Committee in its review. On August 25, 2005, the Corporation announced the receipt of a letter from the SEC in which the SEC indicated that it was conducting an informal inquiry into the Corporation. On October 21, 2005, the Corporation announced that the SEC had issued a formal order of investigation into the accounting for the mortgage related transactions with Doral and R\&G. The Corporation announced on December 13, 2005 that management, with the concurrence of the Board of Directors, determined to restate its previously reported financial statements to correct its accounting for the mortgage-related transactions. The Corporation has fully cooperated with the SEC s investigation. In August 2006, the Audit Committee completed its review and the Corporation filed the Amended 2004 Form 10-K with the SEC on September 26, 2006, the 2005 Form 10-K on February 9, 2007 and the 2006 Form 10-K on July 9, 2007.

On August 7, 2007, First BanCorp announced that the SEC approved a final settlement with the Corporation, which resolves the previously disclosed SEC investigation of the Corporation. Under the settlement, 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 pay 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 will have 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 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.

Following the announcement of the Audit Committee s review, the Corporation and certain of its current and former officers and directors were named as defendants in five separate securities class actions filed between October 31, 2005 and December 5, 2005, alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. At present, all securities class actions have been consolidated into one case named In Re: First BanCorp Securities Litigations . Subsequently, in 2007, the Corporation reached an agreement in principle and signed a memorandum of understanding with the lead plaintiff. The agreement specified a payment of $\$ 74.25$ million by the Corporation subject to the approval by the United States District Court for the District of Puerto Rico.

On August 1, 2007, the United States District Court for the District of Puerto Rico issued a Preliminary Order approving the stipulation of settlement filed in connection with the proposed settlement of the class action lawsuit brought on behalf of First BanCorp s shareholders against the Corporation in the amount of $\$ 74.25$ million.

The effectiveness of a final order to be issued by the Court is subject to:
The payment of $\$ 61$ million to be deposited by First BanCorp in a settlement fund within fifteen calendar days of the date of issuance of the Preliminary Order; and
The mailing of a notice to shareholders that describes the general terms of the settlement.

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The court hearing for the final order of approval of the settlement has been set for October 15, 2007. First BanCorp intends to comply with the $\$ 61$ million payment requirement within the timeframe set forth in the terms of the settlement. The remaining amount of $\$ 13,250,000$ will be paid before December 31, 2007. The monetary payment will have no impact on the Corporation s earnings or capital in 2007. As reflected in First BanCorp s audited Consolidated Financial Statements, included in the Corporation s 2005 Annual Report on Form 10-K, the Corporation accrued $\$ 74.25$ million in 2005 for a possible settlement of the class action.

The Corporation expects to seek recovery of a total of approximately $\$ 14.75$ million from its insurance companies and from former executives of the Corporation. Since agreements with the insurance carriers have not been executed, the Corporation cannot provide assurances that the monies from the insurance carriers will be received and consequently, the Corporation has not made accruals for any potential payment from its insurance carriers.

Between November 8, 2005 and March 7, 2006, several shareholders of the Corporation commenced five separate derivative actions against certain current and former executive officers and directors of the Corporation. In these actions, the Corporation was included as a nominal defendant. These actions were filed pursuant to Section 304 of the Sarbanes-Oxley Act of 2002 and alleged, among other things, a breach of fiduciary duty on behalf of the defendants. All shareholder derivative actions were consolidated into one case named In Re: First BanCorp Derivative Litigation which was dismissed on November 30, 2006 before the U.S. District Court for the District of Puerto Rico.

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## 18 FIRST BANCORP (Holding Company Only) Financial Information

The following condensed financial information presents the financial position of the Holding Company only at September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004 and the results of its operations for the quarter and nine-month period ended on September 30, 2006, 2005 and 2004.


## Liabilities \& Stockholders Equity

Liabilities:

| Other borrowings | $\$ 231,695$ | $\$$ | 295,446 | $\$$ | 298,660 | $\$$ | 321,668 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Accounts payable and other liabilities | 152,559 |  | 83,870 |  | 960 | 1,689 |  |
| Total liabilities | 384,254 |  | 379,316 |  | 299,620 |  | 323,357 |
| Stockholders equity | $1,224,515$ | $1,197,841$ |  | $1,254,759$ | $1,172,647$ |  |  |
| Total liabilities and stockholders equity | $\$ 1,608,769$ | $\$ 1,577,157$ | $\$$ | $1,554,379$ | $\$$ | $1,496,004$ |  |

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Income:

| Interest income on investment securities | \$ | 178 | \$ | 663 | \$ | 323 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest income on other investments |  | 171 |  | 2,309 |  | 532 |
| Interest income on loans |  | 3,068 |  | 3,085 |  | 1,267 |
| Dividend from FirstBank Puerto Rico |  | 41,297 |  | 50,644 |  | 46,277 |
| Dividend from other subsidiaries |  | 13,500 |  | 240 |  | 2,770 |
| Other income |  | 400 |  | 583 |  | 441 |
|  |  | 58,614 |  | 57,524 |  | 51,610 |
| Expense: |  |  |  |  |  |  |
| Federal funds purchased and repurchase agreements |  |  |  |  |  | 2 |
| Notes payable and other borrowings |  | 13,423 |  | 11,861 |  | 2,548 |
| Interest on funding to subsidiaries |  | 3,265 |  |  |  |  |
| (Recovery) provision for loan losses |  | (71) |  |  |  |  |
| Other operating expenses |  | 4,036 |  | 892 |  | 592 |
|  |  | 20,653 |  | 12,753 |  | 3,142 |
| (Loss) gain on sale of investments, net |  | $(10,989)$ |  | 6,297 |  | 4,275 |
| Income before income tax provision and equity in undistributed earnings of subsidiaries |  | 26,972 |  | 51,068 |  | 52,743 |
| Income tax benefit (provision) |  | 320 |  | (66) |  | (98) |
| Equity in undistributed earnings of subsidiaries |  | 35,056 |  | 88,924 |  | 82,986 |
| Net income |  | 62,348 | \$ | 139,926 | \$ | 135,631 |
|  |  |  |  |  |  |  |

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## 19. SUBSEQUENT EVENTS

Following the close of the third quarter of 2006, a number of events have occurred including:
Effective January 1, 2007, the Corporation elected to early adopt SFAS 159 for the callable brokered CDs and a portion of the callable medium-term notes that were previously recognized under the long-haul method as hedged against certain interest rate swaps under SFAS 133. Refer to Note 2 for additional information on the adoption of SFAS 159.

In February 2007, the Corporation entered into various agreements with R\&G relating to prior transactions originally treated as purchases of mortgages 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 has outstanding with the Corporation. In addition, the remaining balance of approximately $\$ 271$ million was re-documented as a secured loan from the Corporation to R\&G. Second, R\&G and the Corporation amended various agreements involving approximately $\$ 218$ 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. The agreements enable First BanCorp to fulfill the remaining requirement of the Consent Order signed with banking regulators relating to the mortgage-related transactions with R\&G that First BanCorp recharacterized for accounting and legal purposes as commercial loans secured by the mortgage loans and pass-through trust certificates.

During the first quarter of 2007, the Corporation announced that it had entered into a definitive agreement to issue approximately 9.250 million shares of its common stock to The Bank of Nova Scotia ( Scotiabank ), through a private placement offering, valuing the stock at $\$ 10.25$ per share for a total purchase price of approximately $\$ 94.8$ million. The valuation reflects a premium of approximately $5 \%$ over the volume weighted- average closing share price over the 30 trading-day period ending January 30, 2007. After the investment, Scotiabank will hold approximately $10 \%$ of First BanCorp s currently outstanding common shares. The original agreement provided that the agreement may be terminated at any time prior to the closing by either the Corporation or Scotiabank if the closing did not occur by July 31, 2007 (the
Termination Date ). The agreement was subsequently amended to change the Termination Date to August 31, 2007. On August 9, 2007, First BanCorp announced the approval by the Federal Reserve Board of the private placement offering with Scotiabank.

On August 1, 2007, the United States District Court for the District of Puerto Rico issued a Preliminary Order approving the stipulation of settlement filed in connection with the proposed settlement of the class action lawsuit brought on behalf of First BanCorp s shareholders against the Corporation in the amount of $\$ 74.25$ million.

The effectiveness of a final order to be issued by the Court is subject to:

- The payment of $\$ 61$ million to be deposited by First BanCorp in a settlement fund within fifteen calendar days of the date of issuance of the Preliminary Order; and
- The mailing of a notice to shareholders that describes the general terms of the settlement.

The court hearing for the final order of approval of the settlement has been set for October 15, 2007. First BanCorp intends to comply with the $\$ 61$ million payment requirement within the timeframe

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set forth in the terms of the settlement. The remaining amount of $\$ 13,250,000$ will be paid before December 31, 2007. The monetary payment will have no impact on the Corporation s earnings or capital in 2007. As reflected in First BanCorp s audited Consolidated Financial Statements, included in the Corporation s 2005 Annual Report on Form 10-K, the Corporation accrued $\$ 74.25$ million in 2005 for a possible settlement of the class action.

On August 7, 2007, First BanCorp announced that the SEC approved a final settlement with the Corporation, which resolves the previously disclosed SEC investigation of the Corporation. Under the settlement, 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 pay 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 will have 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 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.

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## ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (MD\&A)

## Restatement of Previously Issued Financial Statements

On September 26, 2006, First BanCorp filed with the SEC its amended 2004 Annual Report on Form 10-K/A, which included a restatement of the Corporation s audited financial statements for the years ended December 31, 2004, 2003 and 2002 and unaudited selected quarterly financial information for each of the four quarters of 2004, 2003 and 2002 (the 2004 restatement ). This Quarterly Report on Form 10-Q includes financial information for the quarter ended September 30, 2004, as restated. The restatement reflects adjustments necessary to correct accounting errors relating to the following:

Accounting for derivative instruments and broker placement fees;
Recharacterization of purchases of mortgage loans and pass-through trust certificates as commercial loans secured by mortgage loans;

Accounting for investment securities;
Accounting for deferral and recognition of origination fees and costs on loans; and
Other accounting adjustments and reclassifications, including adjustments to the gain on sale of credit card portfolios, accrual for rental expense on lease contracts, valuation of financial instruments and income from a loan origination subsidiary.
In addition, with the filing of its 2006 Annual Report on Form 10-K, First BanCorp restated its 2005 and 2004 Statements of Cash Flows due to some incorrect classifications. The classification errors related to three main items: 1) the treatment of discounts and the related accretion activity on certain investment securities, 2) the classification of cash flows from the disposition of repossessed assets, and 3) purchases of zero coupon bonds and agency discount notes amounts presented as part of investing activities.

The filing of this Quarterly Report on Form 10-Q was delayed because of the time required to complete the 2004 restatement. For more information on the Corporation s 2004 restatement, refer to Item 8, Financial Statements and Supplementary Data, Note 1 Restatement of Previously Issued Financial Statements in the Corporation s amended 2004 Annual Report on Form 10-K. For more information on the Corporation s 2006 restatement, refer to Item 8, Financial Statements and Supplementary Data, Note 1 Restatement of 2005 and 2004 Consolidated Statements of Cash Flows to First BanCorp audited Consolidated Financial Statements, included in the Corporation s 2006 Annual Report on Form 10-K. For more information on the impact of the 2004 and 2006 restatements on the Corporation s financial statements for the quarter and nine month period ended September 30, 2004, refer to Note 1 to the accompanying unaudited interim consolidated financial statements contained in this Quarterly Report on Form 10-Q.

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## SELECTED FINANCIAL DATA

(In thousands except for per share and financial ratios results)

|  |  | Quarter ended September 30, |  | Nine Month Period Ended September 30, |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2006 |  | $2004$ | 2006 | 2005 | $2004$ |
|  |  |  | Restated) |  |  | Restated) |
| Condensed Income |  |  |  |  |  |  |
| Statements: |  |  |  |  |  |  |
| Total interest income | \$317,711 | \$292,263 | \$186,664 | \$989,859 | \$753,797 | \$498,083 |
| Total interest expense | 195,009 | 225,520 | 16,058 | 668,100 | 428,707 | 193,707 |
| Net interest income | 122,702 | 66,743 | 170,606 | 321,759 | 325,090 | 304,376 |
| Provision for loan and |  |  |  |  |  |  |
| lease losses | 20,560 | 12,861 | 13,200 | 49,290 | 34,890 | 39,600 |
| Non-interest income | 8,045 | 17,693 | 11,692 | 20,416 | 51,363 | 44,802 |
| $\begin{array}{lllllll}\text { Non-interest expenses } & 72,940 & 60,555 & 45,877 & 215,718 & 169,635 & 134,192\end{array}$ |  |  |  |  |  |  |
| Income before income taxes | 37,247 | 11,020 | 123,221 | 77,167 | 171,928 | 175,386 |
| Income tax |  |  |  |  |  |  |
| Net income | 26,682 | 17,305 | 88,393 | 62,348 | 139,926 | 135,631 |
| Net income attributable to commonstockholders | 16,613 | 7,236 | 78,324 | 32,141 | 109,719 | 105,424 |
| Per Common Share |  |  |  |  |  |  |
| Results (1): |  |  |  |  |  |  |
| Net income per share basic | \$ 0.20 | \$ 0.09 | \$ 0.97 | \$ 0.39 | \$ 1.36 | \$ 1.31 |
| Net income per share |  |  |  |  |  |  |
| diluted | \$ 0.20 | \$ 0.09 | \$ 0.94 | \$ 0.39 | \$ 1.32 | \$ 1.27 |
| Cash dividends declared | \$ 0.07 | \$ 0.07 | \$ 0.06 | \$ 0.21 | \$ 0.21 | \$ 0.18 |
| Average shares outstanding | 83,254 | 80,875 | 80,484 | 82,694 | 80,837 | 80,348 |
| Average shares |  |  |  |  |  |  |
| outstanding diluted | 83,337 | 82,926 | 83,008 | 83,054 | 83,055 | 82,828 |
| Book value per share | \$ 8.10 | \$ 8.71 | \$ 7.73 | \$ 8.10 | \$ 8.71 | \$ 7.73 |
| Selected Financial |  |  |  |  |  |  |
| Ratios (In Percent): |  |  |  |  |  |  |
| Profitability: |  |  |  |  |  |  |
| Return on Average Assets | 0.55 | 0.36 | 2.46 | 0.42 | 1.07 | 1.36 |
| Interest Rate Spread | 2.14 | 2.67 | 3.45 | 2.35 | 2.87 | 3.15 |
| Net Interest Margin | 2.65 | 3.04 | 3.73 | 2.83 | 3.23 | 3.44 |
| Return on Average Total |  |  |  |  |  |  |
| Equity | 8.90 | 5.38 | 31.23 | 7.01 | 15.13 | 16.31 |
| Return on Average |  |  |  |  |  |  |
| Common Equity | 10.31 | 3.95 | 54.24 | 6.72 | 21.38 | 25.17 |
| Average Total Equity to |  |  |  |  |  |  |
| Average Total Assets | 6.20 | 6.72 | 7.86 | 5.99 | 7.09 | 8.35 |


| Dividend payout ratio | 35.08 | 78.24 | 6.17 | 54.33 | 15.47 | 13.73 |
| :--- | :--- | :--- | ---: | ---: | ---: | ---: |
| Efficiency ratio (2) | 55.79 | 71.72 | 25.17 | 63.04 | 45.06 | 38.43 |

Asset Quality:
Allowance for loan and
lease losses to loans

| receivable <br> Net charge-offs <br> (annualized) to average | 1.39 | 1.20 | 1.59 | 1.39 | 1.20 | 1.59 |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| loans | 0.60 | 0.39 | 0.47 | 0.51 | 0.36 | 0.50 |  |
| Provision for loan and <br> lease losses to net <br> charge-offs | 1.27 | 1.09 | 1.37 | 1.06 | 1.16 | 1.38 |  |
| Other Information: <br> Common Stock Price: | $\$ 11.06$ | $\$ 16.92$ | $\$ 24.15$ | $\$$ | 11.06 | $\$$ | 16.92 |$\$ 24.15$



1- Adjusted to
reflect
two-for-one
stock split
effective
June 30, 2005.
2- Non-interest expense to the sum of net interest income and non-interest income. The denominator includes non-recurring items and changes in the fair value of
derivative
instruments.

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## OVERVIEW OF RESULTS OF OPERATIONS

This discussion and analysis relates to the accompanying consolidated interim unaudited financial statements of First BanCorp ( the Corporation or First BanCorp ) and should be read in conjunction with the interim unaudited financial statements and the notes thereto.

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 characteristics of these assets and liabilities. 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 insurance income and service charges and fees on loans and deposits), the result of its hedging activities, gains (losses) on investments, gains (losses) on sale of loans, and income taxes.

As previously reported, on March 31, 2005, the Corporation completed the acquisition of $100 \%$ of the outstanding common shares of Ponce General Corporation, the holding company of FirstBank Florida (formerly known as Unibank), a thrift subsidiary, and Ponce Realty. This acquisition will allow First BanCorp to build a larger platform in Florida from which to initiate further expansion into the United States. As of March 31, 2005, excluding the effects of purchase accounting entries, Ponce General had approximately $\$ 546.2$ million in assets and $\$ 439.1$ million in deposits. Ponce General assets were mainly comprised of $\$ 476.0$ million in loans ( $\$ 425.8$ million commercial and residential mortgage loans; $\$ 28.2$ million commercial and construction loans; and $\$ 22.1$ million consumer loans). In connection with the purchase, the Corporation paid a cash premium of approximately $\$ 36$ million that was mainly allocated to core deposit intangibles and goodwill.

For the quarter ended September 30, 2006, the Corporation recorded a net income of $\$ 26.7$ million, compared to net income of $\$ 17.3$ million and $\$ 88.4$ million for the quarters ended September 30, 2005 and 2004, respectively. For the quarter ended September 30, 2006, diluted earnings per common share amounted to $\$ 0.20$, compared to $\$ 0.09$ and $\$ 0.94$, for the comparable periods in 2005 and 2004, respectively. Return on average assets and return on average common equity were $0.55 \%$ and $10.31 \%$ respectively, for the third quarter of 2006 as compared to $0.36 \%$ and $3.95 \%$ and $2.46 \%$ and $54.24 \%$, respectively, for the same quarter of 2005 and 2004, respectively. The Corporation s financial performance for the third quarter of 2006, as compared to the third quarter of 2005, was principally impacted by: (1) positive variances in the valuation of derivative instruments mainly due to market conditions and the adoption of fair value hedge accounting using the long-haul method, (2) other-than-temporary impairment charges of $\$ 9.1$ million on certain equity securities held in the Corporation s available-for-sale investment portfolio, (3) a higher provision for loan and lease losses, and (4) higher non-interest expenses, mainly due to higher employees compensation and benefits coupled with higher professional service fees associated with the Audit Committee s review and the restatement process.

The highlights and key drivers of the Corporation s financial results for the quarter ended September 30, 2006 included the following:

For the quarter ended September 30, 2006, the Corporation s operations resulted in a net income of $\$ 26.7$ million, compared to $\$ 17.3$ million and $\$ 88.4$ million for the quarters ended September 30, 2005 and 2004, respectively. After payment of preferred stock dividends, the Corporation s net income available to common stockholders amounted to $\$ 16.6$ million, $\$ 7.2$ million, and $\$ 78.3$ million for the quarters ended September 30, 2006, 2005, and 2004, respectively.

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Diluted earnings per common share for the quarter ended September 30, 2006 was $\$ 0.20$, compared to $\$ 0.09$ and $\$ 0.94$ for the quarters ended September 30, 2005 and 2004, respectively.

Net interest income for the quarters ended September 30, 2006, 2005, and 2004 was $\$ 122.7$ million, $\$ 66.7$ million, and $\$ 170.6$ million, respectively. Net interest income fluctuated significantly due to changes in the valuation of derivatives instruments. For the quarter ended September 30, 2006, the Corporation recorded net unrealized gains of $\$ 2.8$ million in the valuation of derivative instruments, compared to net unrealized losses of $\$ 61.2$ million and unrealized gains of $\$ 62.7$ million for the same period in 2005 and 2004, respectively. Refer to the Net Interest Income discussion for further details.

On a tax equivalent basis, excluding the changes in the fair values of derivative instruments, the ineffective portion resulting from fair value hedge accounting as well as the basis adjustment amortization or accretion (for definition and reconciliation of this non-GAAP measure, refer to the Net Interest Income discussion below), net interest income for the quarters ended September 30, 2006, 2005, and 2004 was $\$ 124.5$ million, $\$ 141.9$ million, and $\$ 130.8$ million, respectively. The decrease in tax equivalent net interest income, when excluding the changes in the fair values of derivative instruments, the ineffective portion resulting from fair value hedge accounting as well as the basis adjustment amortization or accretion, was principally due to margin compressions due to the flattening of the yield curve and fluctuations in net interest incurred on interest rate swaps. The interest margin on a tax equivalent basis was $2.65 \%$ for the quarter ended September 30, 2006, compared to $3.04 \%$ and $3.73 \%$ for the same period in 2005 and 2004, respectively. The decrease in the Corporation s net interest margin on a tax equivalent basis has been particularly significant with respect to the Corporation s portfolio of investment securities. The interest rate spread on the Corporation s portfolio of investment securities (allocating a funding cost equal to the weighted-average cost of the Corporation s other borrowed funds) was approximately $0.22 \%$ for the quarter ended September 30, 2006 compared to $1.60 \%$ for the quarter ended September 30, 2005. Increases in short-term rates resulted in a change in net interest settlements on interest rate swaps included as part of interest expense. For the quarter ended September 30, 2006, the net interest settlement on such interest rate swaps resulted in additional charges of $\$ 6.0$ million to interest expense, compared to benefits of $\$ 16.4$ million recognized as a reduction to interest expense for the same period in 2005, as the rates paid by the Corporation under the variable portion of the swaps exceeded the rates received by the Corporation under the fixed portion of the swap.

The increase in tax equivalent net interest income for 2005, compared to 2004, was mainly driven by higher average balance of loans receivable, particularly the residential and commercial loan portfolios. The increase was partially offset by interest rate margin compression due to the flattening of the yield curve and fluctuations in net interest realized on interest rate swaps.

For the quarter ended September 30, 2006, the Corporation provided $\$ 20.6$ million for loan and lease losses, compared to $\$ 12.9$ million and $\$ 13.2$ million for the same period in 2005 and 2004, respectively. The increase in the provision for the third quarter of 2006 was mainly due to increasing trends in non-accruing loans and charge-offs experienced during 2006 compared to 2005 . The increase in non-accruing loans was mainly due to increases in delinquencies in the residential real estate and commercial loans portfolios. Delinquency trends were affected by the fiscal and economic situation in Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico is in a midst of a recession. The decrease in the provision in the third quarter of 2005, compared to the same period in 2004, was mainly due to the seasoning of the Corporation s corporate commercial loans portfolio.

Non-interest income for the third quarter of 2006 was $\$ 8.0$ million, compared to $\$ 17.7$ million and $\$ 11.7$ million for the same periods in 2005 and 2004, respectively. The decrease in non-interest income for the third quarter of 2006, compared to 2005, was mainly due to higher other-than-temporary impairment

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charges to the Corporation s available-for-sale investment portfolio as well as lower gains on sales of investments partially offset by higher income in the Corporation s mortgage banking and insurance activities. The increase during the third quarter of 2005 as compared to the same period in 2004 was principally due to increases in net gains on investments, insurance income, and service charges on deposit accounts and loans partially offset by lower income from mortgage banking activities.

Non-interest expenses for the third quarter of 2006 amounted to $\$ 72.9$ million, compared to $\$ 60.6$ million and $\$ 45.9$ million, for the same periods in 2005 and 2004, respectively. The increase in non-interest expenses for 2006 was mainly driven by increases in employees compensation and benefits, professional fees associated with the internal review conducted by the Corporation s Audit Committee, the restatement process and other related legal and regulatory matters, rate and coverage of directors and officers liability insurance, and higher occupancy and equipment costs associated with the expansion of the Corporation s branch network. The increase in non-interest expenses for the third quarter of 2005 compared to 2004 mainly reflects increases in compensation and benefits, occupancy and equipment, professional service fees, as well as servicing and processing fees.

For the quarter ended September 30, 2006, the Corporation reported an income tax expense of $\$ 10.6$ million, compared to an income tax benefit of $\$ 6.3$ million and an income tax expense of $\$ 34.8$ million for the corresponding period in 2005 and 2004, respectively. The variance in the income tax provision for the third quarter of 2006 as compared to the third quarter of 2005 was mainly due to a reduction in deferred tax benefits associated with changes in the valuation of derivative instruments coupled with an increase in the current income tax provision. The Corporation recognized a deferred tax benefit of $\$ 9.1$ million for the third quarter of 2006 compared to $\$ 24.7$ million for the same quarter in 2005. The income tax benefit for the third quarter of 2005, compared to the income tax expense recognized during the third quarter of 2004, was also driven by changes in deferred taxes, mainly attributable to changes in the fair value of derivative instruments. The Corporation recognized net unrealized losses on derivative instruments of approximately $\$ 61.2$ million during the third quarter of 2005 compared to net unrealized gains of approximately $\$ 62.7$ million recognized during the third quarter of 2004.

Total assets at September 30, 2006 amounted to $\$ 17.4$ billion, a decrease of $\$ 2.5$ billion and $\$ 1.9$ billion compared to total assets at December 31, 2005 and September 30, 2005, respectively, and an increase of $\$ 2.2$ billion compared to total assets at September 30, 2004. The decrease at September 30, 2006 compared to balances at December 31, 2005 and September 30, 2005 primarily reflects decreases in total loans and total investments including money market instruments. The decrease in the Corporation s loans portfolio was mainly due to the payment received, during the second quarter of 2006, to reduce a secured commercial loan extended to a local financial institution. During the second half of 2006, the Corporation used the proceeds from the repayment to pay down maturing brokered CDs, thus de-leveraging the balance sheet. The Corporation s decision to deleverage its balance sheet was influenced, among other things, by the flat- to-inverted yield curve. As a result, the Corporation decided to repay higher rate maturing liabilities, in particular brokered CDs, rather than investing the proceeds at an effective rate lower that the Corporation s cost of funds. The increase in total assets at September 30, 2006, compared to balances at September 30, 2004, was mainly due to an increase in the Corporation s loan portfolio driven by internal loan originations.

Total liabilities at September 30, 2006 were $\$ 16.2$ billion, a decrease of $\$ 2.6$ billion and $\$ 1.9$ billion as compared to balances at December 31, 2005 and September 30, 2005, respectively, and an increase of $\$ 2.2$ billion compared to balances as of September 30, 2004. The decrease in total liabilities during 2006, compared to 2005, was mainly attributable to decreases in FHLB advances, federal funds purchased and securities sold under repurchase agreements and brokered CDs. The payment of $\$ 2.4$ billion received from a local financial institution was used to pay down the aforementioned liabilities. The increase in total liabilities for

2006, compared to 2004, was mainly due to increases in interest-bearing deposits primarily brokered CDs partially offset by decreases in FHLB advances and federal funds purchased and securities sold under repurchase agreements.

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Total loan production for the quarter ended September 30, 2006 was $\$ 965.6$ million, compared to $\$ 1.4$ billion and $\$ 1.3$ billion, for the third quarters of 2005 and 2004, respectively. The decrease in loan production was mainly due to decreases in residential real estate, commercial, construction, and consumer loan originations, mainly due to higher prevailing interest rates, deteriorating economic conditions in Puerto Rico and stricter underwriting standards.

## 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 scritical 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; and 6) derivative financial instruments. 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 at 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 originally reported.

The Corporation s critical accounting policies are described in the Management Discussion and Analysis of Financial Condition and Results of Operations section of First BanCorp s 2005 Annual Report on Form 10-K.

## Recently Adopted Accounting Pronouncement

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 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 that changes in the fair values of derivative do not offset changes in the fair values of the debt due to changes in the hedged risk.

For interest rate swaps accounted for as fair value hedges using the long-haul method, ineffectiveness is the difference between the changes in the fair value of the interest rate swap and changes in the fair value of the debt attributable to the risk being hedged. Prospectively, changes in the value of the Corporation s brokered CDs and medium-term notes should substantially offset the changes in the value of the interest rate swaps.

First BanCorp s implementation of the long-haul method resulted from its previously reported determination that it should not have used the short-cut method to account for interest rate swaps related to brokered CDs and mediumterm notes because of technical issues involving the interpretation of the use of the method (refer to First BanCorp audited Consolidated Financial Statements, included in the Corporation s amended 2004 Annual Report on Form 10-K for additional information). Accordingly, prior to the implementation of the long-haul method, First BanCorp has reflected changes in the fair value of those swaps as well as swaps related to certain loans as non-hedging instruments through operations.

With the implementation of the long-haul method with respect to the brokered CDs and medium-term notes on April 3, 2006, the basis differential between the market value of the interest rate swap and the book value of the hedged liabilities at the inception of fair value hedge accounting, of approximately $\$ 200.0$ million, amortizes or accretes as a yield adjustment over the remaining term of the hedged liabilities.

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Effective January 1, 2007, the Corporation elected to early adopt SFAS 157, Fair Value Measurements and SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. Following the initial fair value measurement date, ongoing realized gains and losses on items for which fair value reporting has been elected are reported in earnings at each subsequent financial reporting date.

The Corporation decided to early adopt SFAS 159 for the callable brokered CDs and a portion of the callable fixed medium-term notes that 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 determining to early adopt SFAS 159 for these instruments was to eliminate the operational procedures required by the long-haul method of accounting in terms of documentation, effectiveness assessment, and manual procedures followed by the Corporation to fulfill the requirements specified by SFAS 133.

With the Corporation s elimination of the use of the long-haul method in connection with the adoption of SFAS 159 as of January 1, 2007, the Corporation will no longer amortize or accrete the basis adjustment. The basis adjustment amortization or accretion is the reversal of the change in value of the 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 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 adoption adjustment, of all of the unamortized placement fees that were paid to broker counterparties upon the issuance of the brokered CDs and medium term notes. The Corporation previously amortized those fees through earnings based on the expected call date of the instruments.

For additional information and further details on the adoption of SFAS 157 and SFAS 159 as well as other recently adopted accounting pronouncements, refer to Note 2 of the accompanying unaudited interim consolidated financial statements.

## 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 quarter and nine-month period ended September 30, 2006 was $\$ 122.7$ million and $\$ 321.8$ million, respectively, compared to $\$ 66.7$ million and $\$ 325.1$ million, respectively, for the comparable periods in 2005 and $\$ 170.6$ million and $\$ 304.4$ million, respectively, for the comparable periods in 2004. On a tax equivalent basis, excluding the changes in the fair values of derivative instruments, the ineffective portion resulting from fair value hedge accounting as well as the basis adjustment amortization or accretion, net interest income for the quarter ended September 30, 2006, 2005, and 2004 was $\$ 124.5$ million, $\$ 141.9$ million, and $\$ 130.8$ million, respectively. On a tax equivalent basis, excluding the changes in the fair values of derivative instruments, the ineffective portion resulting from fair value hedge accounting as well as the basis adjustment amortization or accretion, net interest income for the nine-month periods ended September 30, 2006, 2005, and 2004 was $\$ 409.0$ million, $\$ 411.1$ million, and $\$ 331.4$ million, respectively.

Part I of the following table presents average volumes and rates on a tax equivalent basis and Part II describes the respective extent to which changes in interest rates and changes in volume of interest-related assets and liabilities have affected the Corporation s interest income and interest expense during the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (changes in volume multiplied by prior period rates), (ii) changes in rate (changes in rate multiplied by prior period volumes). Rate-volume variances (changes in rate multiplied by the

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changes in volume) have been allocated to the changes in volume and changes in rate based upon their respective percentage of the combined totals.

For periods after the adoption of fair value hedge accounting, the net interest income is computed on a tax equivalent basis by excluding: (1) the change in the value of derivatives for undesignated hedges, (2) the ineffective portion of designated hedges and (3) the basis adjustment amortization or accretion. For periods prior to the adoption of hedge accounting, the net interest income is computed on a 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).

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## Part I

Quarter ended September 30,

| Average volume |  |  | Interest Income (1) / expense |  |  | Average rate (1) |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| 2006 | 2005 | 2004 | 2006 | 2005 | 2004 | 2006 | 2005 | 2004 |
|  |  | (As |  |  | (As |  |  | (As |
|  |  | Restated) |  |  | Restated) |  |  | Restated) |

(Dollars in thousands)
Earning assets:
Money market

| investments | \$ | 2,300,294 | \$ | 765,629 | \$ | 356,367 | \$ | 31,435 | \$ | 6,607 | \$ | 1,152 | 5.42\% | 3.42\% | 1.29\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Government |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| obligations (2) |  | 2,803,987 |  | 2,603,501 |  | 2,589,137 |  | 40,863 |  | 42,710 |  | 43,694 | 5.78\% | 6.51\% | 6.71\% |
| Mortgage-backed |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Corporate bonds |  | 26,478 |  | $2,927,264$ 49,960 |  | 47,930 |  | 31,420 420 |  | 733 |  | (66) | 6.29\% | 5.82\% | -0.55\% |
| FHLB stock |  | 22,998 |  | 74,345 |  | 61,261 |  | 383 |  | 911 |  | 303 | 6.61\% | 4.86\% | 1.97\% |
| Equity securities |  | 28,973 |  | 60,461 |  | 43,595 |  |  |  | 321 |  | 140 | 0.00\% | 2.11\% | 1.28\% |

Total

| investments (3) | $7,781,362$ | $6,481,160$ | $5,774,954$ | 104,508 | 90,281 | 93,501 | $5.33 \%$ | $5.53 \%$ | $6.44 \%$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Residential real <br> estate loans <br> Construction | $2,676,886$ | $1,928,395$ | $1,160,542$ | 44,176 | 32,245 | 19,955 | $6.55 \%$ | $6.63 \%$ | $6.84 \%$ |
| loans | $1,552,151$ | 793,920 | 394,627 | 34,526 | 14,709 | 5,202 | $8.83 \%$ | $7.35 \%$ | $5.24 \%$ |
| Commercial |  |  |  |  |  |  |  |  |  |
| loans | $4,513,941$ | $7,449,784$ | $5,145,150$ | 87,429 | 104,842 | 48,449 | $7.68 \%$ | $5.58 \%$ | $3.75 \%$ |
| Finance leases | 333,170 | 249,505 | 192,388 | 7,397 | 5,750 | 4,657 | $8.81 \%$ | $9.14 \%$ | $9.63 \%$ |
| Consumer loans | $1,790,141$ | $1,636,720$ | $1,266,659$ | 54,532 | 49,546 | 39,286 | $12.09 \%$ | $12.01 \%$ | $12.34 \%$ |

Total loans

| (4)(5) | $10,866,289$ | $12,058,324$ | $8,159,366$ | 228,060 | 207,092 | 117,549 | $8.33 \%$ | $6.81 \%$ | $5.73 \%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Total earning $\begin{array}{lllllllll}\text { assets } & \$ 18,647,651 & \$ 18,539,484 & \$ 13,934,320 & \$ 332,568 & \$ 297,373 & \$ 211,050 & 7.08 \% & 6.36 \%\end{array} \quad 6.03 \%$

Interest-bearing
liabilities:
Interest-bearing deposits
Other borrowed funds
\$ 12,040,646 \$ 10,879,094 \$ 6,431,652 \$ 148,394 \$ 93,484 \$ 33,426 $4.89 \% \quad 3.41 \% \quad 2.07 \%$
$\begin{array}{llllllllll}\text { FHLB advances } & 214,920 & 481,547 & 1,210,462 & 2,876 & 5,208 & 7,574 & 5.31 \% & 4.29 \% & 2.49 \%\end{array}$
$\begin{array}{llllllllll}\text { Total interest } & \$ 16,704,446 & \$ 16,712,211 & \$ 12,366,280 & \$ 208,119 & \$ 155,482 & \$ 80,277 & 4.94 \% & 3.69 \% & 2.58 \%\end{array}$ -bearing
liabilities

Net interest
income

$$
\$ 124,449 \quad \$ 141,891 \quad \$ 130,773
$$

Interest rate
spread
Net interest

margin $\quad$| $2.14 \%$ | $2.67 \%$ | $3.45 \%$ |
| :--- | :--- | :--- | :--- |

Nine month period ended September 30,

2006 |  | Average volume |  |
| :---: | :---: | :---: |
|  |  | 2005 |
|  |  | 2004 |
| (As |  |  |
|  |  | Restated) |

Interest Income (1) /
expense Average rate (1)
200620052004200620052004
(As
Restated)
(As
Restated)
(Dollars in thousands)
Earning assets:
Money market

| investments | \$ | 1,785,282 | \$ | 466,380 | \$ | 273,115 | \$ | 66,314 | \$ | 10,624 | \$ | 2,415 | 4.97\% | 3.05\% | 1.18\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Government |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| obligations (2) |  | 2,833,935 |  | 2,449,024 |  | 2,036,252 |  | 127,879 |  | 123,418 |  | 96,795 | 6.03\% | 6.74\% | 6.35\% |
| Mortgage-backed securities |  | 2,601,921 |  | 2,728,206 |  | 2,782,698 |  | 99,644 |  | 114,070 |  | 117,861 | 5.12\% | 5.59\% | 5.67\% |
| Corporate bonds |  | 26,345 |  | 52,535 |  | 62,906 |  | 1,278 |  | 1,905 |  | (148) | 6.48\% | 4.85\% | -0.31\% |
| FHLB stock |  | 27,322 |  | 74,049 |  | 54,433 |  | 1,644 |  | 2,278 |  | 633 | 8.04\% | 4.11\% | 1.55\% |
| Equity securities |  | 29,935 |  | 48,582 |  | 44,499 |  | 213 |  | 798 |  | 380 | 0.95\% | 2.20\% | 1.14\% |


| Total |  |  |  |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| investments (3) | $7,304,740$ | $5,818,776$ | $5,253,903$ | 296,972 | 253,093 | 217,936 | $5.44 \%$ | $5.82 \%$ | $5.54 \%$ |


| Residential real <br> estate loans | $2,563,973$ | $1,679,605$ | $1,079,630$ | 126,313 | 85,206 | 57,342 | $6.59 \%$ | $6.78 \%$ | $7.09 \%$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Construction | $1,449,775$ | 592,330 | 371,988 | 93,429 | 30,886 | 13,823 | $8.62 \%$ | $6.97 \%$ | $4.96 \%$ |
| loans |  |  |  |  |  |  |  |  |  |
| Commercial | $5,938,545$ | $7,160,362$ | $4,779,969$ | 313,102 | 276,574 | 128,653 | $7.05 \%$ | $5.16 \%$ | $3.60 \%$ |
| loans | 314,381 | 235,508 | 179,118 | 21,119 | 16,102 | 13,029 | $8.98 \%$ | $9.14 \%$ | $9.72 \%$ |
| Finance leases | $1,779,951$ | $1,522,840$ | $1,217,404$ | 160,734 | 138,814 | 115,970 | $12.07 \%$ | $12.19 \%$ | $12.72 \%$ |

Total loans
$\begin{array}{llllllllll}\text { (4)(5) } & 12,046,625 & 11,190,645 & 7,628,109 & 714,697 & 547,582 & 328,817 & 7.93 \% & 6.54 \% & 5.76 \%\end{array}$
Total earning
$\begin{array}{llllllllll}\text { assets } & \$ 19,351,365 & \$ 17,009,421 & \$ 12,882,012 & \$ 1,011,669 & \$ 800,675 & \$ 546,753 & 6.99 \% & 6.29 \% & 5.67 \%\end{array}$

Interest-bearing
liabilities:
Interest-bearing deposits \$ 12,293,710 \$ 9,288,974 \$ 6,254,889 \$ 418, 152 \$214,268 \$ 92,619 $4.55 \% \quad 3.08 \% \quad 1.98 \%$

| Other borrowed funds | 4,812,494 | 4,886,899 | 4,163,204 |  | 174,582 | 147,816 | 104,027 | 4.85\% | 4.04\% | 3.34\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| FHLB advances | 272,023 | 1,050,455 | 995,104 |  | 9,921 | 27,498 | 18,691 | 4.88\% | 3.50\% | 2.51\% |
| Total interest -bearing |  |  |  |  |  |  |  |  |  |  |
| liabilities | \$ 17,378,227 | \$ 15,226,328 | \$ 11,413,197 | \$ | 602,655 | \$ 389,582 | \$ 215,337 | 4.64\% | 3.42\% | 2.52\% |
| Net interest income |  |  |  | \$ | 409,014 | \$ 411,093 | \$ 331,416 |  |  |  |
| Interest rate spread |  |  |  |  |  |  |  | 2.35\% | 2.87\% | 3.15\% |
| Net interest margin |  |  |  |  |  |  |  | 2.83\% | 3.23\% | 3.44\% |

(1) On a tax equivalent basis. The tax equivalent yield was estimated by dividing the interest rate spread on exempt assets by (1-PR statutory tax rate (43.5\% for the Corporation s PR banking subsidiary in 2006, $41.5 \%$ for all other subsidiaries in 2006, $41.5 \%$ for all subsidiaries in 2005 and $39 \%$ for all subsidiaries in 2004)) 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 of the
instruments after
the adoption of
hedge accounting
in the second
quarter of 2006)
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 is excluded from the average volumes.
(4) Average loan balances include the average of non-accruing loans, of which interest income is recognized when collected.
(5) Interest income on loans includes
$\$ 4.3$ million, $\$ 3.0$ million, and
$\$ 2.4$ million for the third quarter of 2006, 2005, and 2004, respectively, and $\$ 11.3$ million, $\$ 8.0$ million, and $\$ 8.3$ million for the nine month period ended September 30, 2006, 2005 and 2004, respectively, of income from prepayment penalties and late fees related to the Corporation s loans portfolio.

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## PART II

Quarter Ended on September 30,


| Interest income on earning assets: |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Money market investments | \$ 19,230 | \$ | 5,598 | \$ 24,828 | \$ 2,229 | \$ 3,226 | \$ 5,455 |
| Government obligations | 3,073 |  | $(4,920)$ | $(1,847)$ | 293 | $(1,277)$ | (984) |
| Mortgage-backed securities | $(4,156)$ |  | $(3,436)$ | $(7,592)$ | 3,931 | $(13,210)$ | $(9,279)$ |
| Corporate bonds | (357) |  | 44 | (313) | 16 | 783 | 799 |
| FHLB stock | (739) |  | 211 | (528) | 77 | 531 | 608 |
| Equity Securities | (110) |  | (211) | (321) | 68 | 113 | 181 |
| Total investments | 16,941 |  | $(2,714)$ | 14,227 | 6,614 | $(9,834)$ | $(3,220)$ |
| Residential real estate loans | 12,382 |  | (451) | 11,931 | 13,010 | (720) | 12,290 |
| Construction loans | 16,377 |  | 3,440 | 19,817 | 6,806 | 2,701 | 9,507 |
| Commercial loans | $(48,763)$ |  | 31,350 | $(17,413)$ | 26,918 | 29,475 | 56,393 |
| Finance leases | 1,884 |  | (237) | 1,647 | 1,351 | (258) | 1,093 |
| Consumer loans | 4,672 |  | 314 | 4,986 | 11,358 | $(1,098)$ | 10,260 |
| Total loans | $(13,448)$ |  | 34,416 | 20,968 | 59,443 | 30,100 | 89,543 |
| Total interest income | 3,493 |  | 31,702 | 35,195 | 66,057 | 20,266 | 86,323 |

Interest expense on interest-bearing liabilities:

| Deposits | 10,837 | 44,073 | 54,910 | 30,984 | 29,074 | 60,058 |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| Other borrowed funds | $(10,471)$ | 10,530 | 59 | 5,733 | 11,780 | 17,513 |
| FHLB advances | $(3,210)$ | 878 | $(2,332)$ | $(6,177)$ | 3,811 | $(2,366)$ |
| Total interest expense | $(2,844)$ | 55,481 | 52,637 | 30,540 | 44,665 | 75,205 |
| Change in net interest |  |  |  |  |  |  |
| income | $\$ 6,337$ | $\$(23,779)$ | $\$(17,442)$ | $\$ 35,517$ | $\$(24,399)$ | $\$ 11,118$ |

Nine month Period Ended on September 30,

2006 compared to 2005
Increase (decrease)
Due to:
Volume Rate
Total Volume
(In thousands)

2005 compared to 2004 (As Restated)
Increase (decrease)
Due to:
Rate Total

Interest income on earning assets:

| Money market investments | \$ 45,536 | \$ 10,154 | \$ 55,690 | \$ 2,542 | \$ 5,667 | \$ 8,209 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Government obligations | 18,409 | $(13,948)$ | 4,461 | 20,455 | 6,168 | 26,623 |
| Mortgage-backed securities | $(5,123)$ | $(9,303)$ | $(14,426)$ | $(2,356)$ | $(1,435)$ | $(3,791)$ |
| Corporate bonds | $(1,112)$ | 485 | (627) | 20 | 2,033 | 2,053 |
| FHLB stock | $(2,130)$ | 1,496 | (634) | 296 | 1,349 | 1,645 |
| Equity Securities | (236) | (349) | (585) | 38 | 380 | 418 |
| Total investments | 55,344 | $(11,465)$ | 43,879 | 20,995 | 14,162 | 35,157 |
| Residential real estate loans | 44,283 | $(3,176)$ | 41,107 | 31,157 | $(3,293)$ | 27,864 |
| Construction loans | 53,779 | 8,764 | 62,543 | 10,139 | 6,924 | 17,063 |
| Commercial loans | $(56,014)$ | 92,542 | 36,528 | 78,834 | 69,087 | 147,921 |
| Finance leases | 5,353 | (336) | 5,017 | 3,977 | (904) | 3,073 |
| Consumer loans | 23,361 | $(1,441)$ | 21,920 | 28,448 | $(5,604)$ | 22,844 |
| Total loans | 70,762 | 96,353 | 167,115 | 152,555 | 66,210 | 218,765 |
| Total interest income | 126,106 | 84,888 | 210,994 | 173,550 | 80,372 | 253,922 |

Interest expense on interest-bearing liabilities:

| Deposits | 82,643 | 121,241 | 203,884 | 56,506 | 65,143 | 121,649 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Other borrowed funds | $(2,519)$ | 29,285 | 26,766 | 19,747 | 24,042 | 43,789 |
| FHLB advances | $(24,428)$ | 6,851 | $(17,577)$ | 1,088 | 7,719 | 8,807 |
|  |  |  |  |  |  |  |
| Total interest expense | 55,696 | 157,377 | 213,073 | 77,341 | 96,904 | 174,245 |
| Change in net interest <br> income | $\$ 70,410$ | $\$(72,489)$ | $\$(2,079)$ | $\$ 96,209$ | $\$(16,532)$ | $\$ 79,677$ |

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 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 ( $43.5 \%$ for the Corporation s Puerto Rico banking subsidiary in 2006, 41.5\% for all other subsidiaries in 2006,

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41.5\% for all subsidiaries in 2005 and $39 \%$ for all subsidiaries in 2004)) 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 exclusion of changes in the fair value on derivative instruments, the ineffective portion for designated hedges after adoption of hedge accounting, and the basis adjustment amortization or accretion from the detailed analysis of net interest income provides additional information about the Corporation s net interest income and facilitates comparability and analysis. The changes in the fair value of the financial instruments and the basis adjustment have no effect on interest due or interest earned on interest-bearing liabilities or interest-earning assets, respectively, or on interest payments exchanged with swap counterparties.

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

2006
(In thousands)
Interest income on interest earning assets on a tax equivalent basis
Less: tax equivalent adjustments
Plus: net unrealized (losses) gains on derivatives

Total interest income
\$332,568
\$297,373 \$ 211,050
$(5,377) \quad(13,962) \quad(22,911)$
$(9,480) \quad 8,852 \quad(1,475)$
$\$ 317,711 \quad \$ 292,263 \quad \$ \quad 186,664$
$(13,962) \quad(22,911)$

Quarter ended September 30, 2004
(As
Quarter ended Septenber Restated)
2005

Nine month period ended September 30,
Nine month period ended September 30, 2004 (As 20062005

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


The following table summarizes the components of interest expense for the quarter and nine-month period ended September 30, 2006, 2005 and 2004. As previously stated, the net interest margin analysis excludes the changes in the
fair value of interest rate swaps, the ineffective portion of instruments designated as hedges, and the basis adjustment.

\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline \multirow[b]{4}{*}{(In thousands)} \& \multicolumn{4}{|l|}{Quarter ended September 30} \& Nine $m$ \& \multicolumn{2}{|l|}{30,} \& tember <br>
\hline \& \multirow[t]{3}{*}{Quart

2006} \& \multirow[t]{3}{*}{2005} \& \multicolumn{2}{|l|}{2004} \& \& \& \& 2004 <br>
\hline \& \& \& \& (As \& \& \& \& (As <br>
\hline \& \& \& \& (Atated) \& 2006 \& 2005 \& \& stated) <br>
\hline \multicolumn{9}{|l|}{Interest expense on} <br>
\hline interest-bearing liabilities \& \$ 195,630 \& \$ 166,907 \& \$ \& 109,240 \& \$ 583,154 \& \$ 439,692 \& \$ \& 299,839 <br>
\hline \multicolumn{9}{|l|}{Net interest incurred (realized) on interest rate} <br>
\hline swaps \& 5,980 \& $(16,350)$ \& \& $(32,701)$ \& 4,273 \& $(61,494)$ \& \& $(94,730)$ <br>
\hline \multicolumn{9}{|l|}{Amortization of placement fees on} <br>
\hline brokered CDs \& 6,491 \& 4,917 \& \& 3,084 \& 15,196 \& 11,364 \& \& 9,574 <br>
\hline \multicolumn{9}{|l|}{Amortization of placement fees on} <br>
\hline \multicolumn{9}{|l|}{\multirow[b]{2}{*}{Interest expense excluding unrealized}} <br>
\hline \& \& \& \& \& \& \& \& <br>
\hline derivatives (designated and economic \& \& \& \multicolumn{2}{|c|}{derivatives (designated} \& \& \& \& <br>
\hline \multicolumn{9}{|l|}{undesignated hedges)} <br>
\hline adjustments \& 208,119 \& 155,482 \& \& 80,277 \& 602,655 \& 389,582 \& \& 215,337 <br>
\hline \multicolumn{9}{|l|}{Net unrealized} <br>
\hline derivatives (designated and economic \& \& \& \& \& \& \& \& <br>
\hline undesignated hedges) \& $(12,264)$ \& 70,038 \& \& $(64,219)$ \& 64,987 \& 39,125 \& \& $(21,630)$ <br>
\hline (Accretion) amortization of basis adjustment on \& \& \& \& \& \& \& \& <br>
\hline fair value hedges \& (846) \& \& \& \& 458 \& \& \& <br>
\hline Total interest expense \& \$ 195,009 \& \$ 225,520 \& \$ \& 16,058 \& \$ 668,100 \& \$ 428,707 \& \$ \& 193,707 <br>
\hline
\end{tabular}

The following table summarizes the components of the unrealized loss (gain) on derivatives (designated and economic undesignated hedges), which is included in interest expense.

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Net unrealized gains on derivatives (designated hedges ineffective portion):

Unrealized (gains) losses on derivatives (economic undesignated hedges): Interest rate swaps on brokered CDs
Interest rate swaps on medium-term notes $(10,873)$

| 67,668 | $(64,080)$ | 64,269 | 38,572 |
| ---: | ---: | ---: | ---: |
| 2,370 | $(139)$ | 4,083 | 553 |

Net unrealized (gains) losses on derivatives

Net unrealized (gains) losses on derivatives (designated and economic undesignated hedges $\quad \$(12,264) \quad \$ 70,038 \quad \$ \quad(64,219) \quad \$ 64,987 \quad \$ 39,125 \quad \$ \quad(21,630)$

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The following table summarizes the components of the accretion or amortization of basis adjustment, which is included in interest expense:


Interest income on interest-earning assets primarily represents interest earned on loan receivables 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 swaps that hedge 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).

Unrealized gains or losses on derivatives represent: (1) for economic or undesignated hedges - changes in the fair value of 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 swap) and changes in fair value of the hedged item (i.e., brokered CDs and medium-term notes).

The basis adjustment on fair value hedges 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 that amortizes or accretes to interest expense based on the expected maturity of the hedged liabilities as changes in value since the inception of the long-haul method are recorded to these hedged items.

As shown on the tables above, the results of operations for the third quarter and first nine months of 2006, 2005 and 2004 were significantly impacted by changes in the valuation of interest rate swaps that hedge economically or under fair value designation the Corporation s brokered CDs and medium-term notes. The change in the valuation of interest rate swaps recorded and the ineffective portion on designated hedges recorded as part of interest expense resulted in an unrealized gain of $\$ 12.3$ million and an unrealized loss of $\$ 65.0$ million for the third quarter and first nine months of 2006, respectively (2005- unrealized losses of $\$ 70.0$ million and $\$ 39.1$ million for the third quarter and first nine months, respectively; 2004- unrealized gains of $\$ 64.2$ million and $\$ 21.6$ million for the third quarter and first nine months, respectively). Effective April 3, 2006, the Corporation implemented fair value hedge accounting for the majority of its interest rate swaps ( $98 \%$ of the interest rate swap portfolio outstanding) that economically hedge brokered CDs and certain medium-term notes payable which substantially eliminated the impact of the fluctuation in the valuation of the interest rate swaps after April 3, 2006. As part of the implementation, the Corporation formally documented the relationship between the interest rate swaps and hedged liabilities under the long-haul method of effectiveness testing.

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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 payments on its brokered CDs and medium-term notes to variable payments (received fixed/pay floating). Refer to the Risk Management Derivatives section below for further detail 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 the values 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.
2006 compared to 2005. First BanCorp s net interest income increased by $\$ 56.0$ million for the third quarter of 2006 compared to the same period in 2005. The increase in net interest income for the third quarter of 2006 was mainly driven by fluctuations in the valuation of derivative instruments and the adoption of fair value hedge accounting, and to the re-pricing of variable rate loans. These positive factors were partially offset by a reduction in the net interest margin due to the flattening of the yield curve. For the third quarter of 2006, the change in the valuation of interest rate swaps including the ineffective portion on designated hedges recorded as part of interest expense resulted on unrealized gains of $\$ 12.3$ million compared to unrealized losses of $\$ 70.0$ million for the same period in 2005. The positive fluctuation in the valuation of derivative instruments reflects decreasing long term interest rates during the third quarter of 2006 coupled with a significant reduction in the volume of undesignated derivatives due to the fair value hedge accounting implementation in 2006.

For the nine-month period ended September 30, 2006, the Corporation s net interest income decreased by $\$ 3.3$ million or $1 \%$ compared to the same period in 2005 . The slight decrease in net interest income was mainly due to an increase in unrealized losses in the valuation of derivative instruments coupled with a higher costs of interest-bearing liabilities due to the re-pricing and issuance of brokered CDs at higher rates, FHLB advances and other borrowed funds. These negative factors were partially offset by higher yields on loans mainly due to new loans originated at higher rates and to the re-pricing of variable rate loans. The majority of the Corporation s commercial and construction loan portfolios are variable rate loans tied to short-term-rates indexes, mainly LIBOR and Prime rates. For the first nine months of 2006, the changes in the valuation of interest rate swaps recorded as part of interest expense resulted in unrealized losses of $\$ 65.0$ million compared to unrealized losses of $\$ 39.1$ million for the same period in 2005. For the first nine months of 2006, the Corporation recognized as a reduction to interest expense, approximately $\$ 3.4$ million representing ineffectiveness of the hedges of its brokered CDs and medium term notes that qualify as fair value hedges under SFAS 133.

On a tax equivalent basis, net interest income, excluding the changes in the fair values of derivative instruments, the ineffective portion for designated hedges, and basis adjustment amortization or accretion, decreased by $\$ 17.4$ million, or $12 \%$, and $\$ 2.1$ million, or $0.5 \%$, for the third quarter and first nine months of 2006 , respectively, as compared to the same periods in 2005. The decrease in tax equivalent net interest income was principally due to margin compressions due to the flattening of the yield curve and fluctuations in net interest incurred on interest rate swaps. First BanCorp s net interest spread and margin for the quarter and nine month period ended September 30, 2006 were $2.14 \%$ and $2.65 \%$ and $2.35 \%$ and $2.83 \%$, respectively, compared to $2.67 \%$ and $3.04 \%$ and $2.87 \%$ and $3.23 \%$, respectively, for the same periods in 2005. The decrease in the net interest rate spread and margin during 2006 was mainly attributable 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 a significant component of the Corporation s earnings. The decrease in the Corporation s net interest margin has been particularly significant with respect to the Corporation s portfolio of investment securities. The interest rate spread on the Corporation s portfolio of investment securities (allocating a funding cost equal to the weighted-average cost

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of the Corporation s other borrowed funds) was approximately $0.22 \%$ and $0.74 \%$ for the quarter and nine-month period ended September 30, 2006 compared to $1.60 \%$ and $2.02 \%$ for the same period in 2005. The tax equivalent yield on interest earning assets increased by 72 and 70 basis points during the third quarter and first nine months of 2006, compared to the same periods in 2005, mainly due to the repayment of approximately $\$ 2.4$ billion from a local financial institution reducing the balance of lower yielding loans during the second quarter of 2006 and to the re-pricing of variable rate commercial and construction loans as well as the origination of new commercial and construction loans in an increasing interest rate environment. The average rate paid by the Corporation on its interest-bearing liabilities increased by 125 basis points and 122 basis points during the third quarter and first nine months of 2006 when compared to the same periods in 2005, mainly due to the re-pricing of the Corporation s interest-bearing deposits, principally time deposits, FHLB advances, and other borrowed funds.

The increase in short term rates resulted in a change in net payments on interest rate swaps included as part of interest expenses. For the third quarter and nine months ended September 30, 2006, the net settlement payments on such interest rate swaps resulted in charges of $\$ 6.0$ million and $\$ 4.3$ million, respectively, to interest expenses, or a net increase of $\$ 22.3$ million and $\$ 65.8$ million, respectively, in interest expense compared to the same periods in 2005, as the rates under the variable leg of the swaps exceeded the rates received.
2005 compared to 2004. First BanCorp s net interest income decreased by $\$ 103.9$ million for the third quarter of 2005 compared to the same period in 2004. The decrease in net interest income was mainly due to negative fluctuations in the valuation of interest rate swaps that economically hedge brokered CDs and medium-term notes coupled with higher cost of interest-bearing liabilities due to the re-pricing of brokered CDs, FHLB advances and other borrowed funds. These negative factors were partially offset by a growth in the average volume of interest-earnings assets of $\$ 4.6$ billion or $33 \%$, for the third quarter of 2005 as compared to the same period of 2004, attributable primarily to the growth in the Corporation s loans and investment portfolios, in particular commercial and residential real estate loan portfolios as well as mortgage-backed securities and by higher yields on loans mainly due to new loans originated in an increasing interest rates environment and to the re-pricing of variable rate loans. The majority of the Corporation s commercial and construction loan portfolios are variable rate loans tied to short-term rates indexes, mainly LIBOR and Prime rates. For the third quarter of 2005, the changes in the valuation of interest rate swaps recorded as part of interest expense resulted in unrealized losses of $\$ 70.0$ million compare to unrealized gains of $\$ 64.2$ million for the same period in 2004. The negative changes in the valuation of interest rate swaps were mainly due to the increase in long-term interest rates experienced during 2005.

For the nine-month period ended September 30, 2005, the Corporation s net interest income increased by $\$ 20.7$ million or $7 \%$ compared to the same period in 2004. The increase in net interest income for the first nine months of 2005 was mainly driven by an increase in the average volume of interest-earning assets of $\$ 4.1$ billion or $32 \%$, compared to 2004, attributable primarily to the growth in the Corporation s loan and investment portfolios, in particular residential real estate loan, commercial and construction loan portfolios as well as government agency securities. In addition to volume increases, higher yields on loans favorably impacted net interest income caused by higher short-term interest rates experienced during 2005 as compared to 2004. A substantial portion of commercial and construction loan portfolios are variable rate loans tied to short term-rates indexes, mainly LIBOR and Prime rate. These positive factors were partially offset by higher cost of funds and negative fluctuations in the valuation of derivative instruments, mainly interest rate swaps that economically hedge brokered certificates of deposits and medium term notes. For the first nine months of 2005, the changes in the valuation of interest rate swaps recorded as part of interest expense resulted in unrealized losses of $\$ 39.1$ million compare to unrealized gains of $\$ 21.6$ million for the same period in 2004. The negative changes in the valuation of interest rate swaps were mainly due to the increase in long-term interest rates experienced during 2005.

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On a tax equivalent basis, the Corporation s net interest income, excluding the changes in the fair values of derivative instruments, increased by $\$ 11.1$ million, or $9 \%$, and $\$ 79.7$ million, or $24 \%$, for the third quarter and first nine months of 2005 , respectively, as compared to the same periods in 2004. The increase in tax equivalent net interest income for the third quarter and first nine months of 2005 was mainly due to an increase in the Corporation s average earning assets partially offset by a decrease in net interest margin and net interest realized on interest rate swaps. First BanCorp s net interest spread and margin for the quarter and nine month period ended September 30, 2005 were $2.67 \%$ and $3.04 \%$ and $2.87 \%$ and $3.23 \%$, respectively, compared to $3.45 \%$ and $3.73 \%$ and $3.15 \%$ and $3.44 \%$, respectively, for the same periods in 2004. The decrease in net interest rate spread and margin during 2005 was due primarily to the upward trend of short-term interest rates and the flattening of the yield curve, as well as the re-pricing and maturity mismatch of the Corporation s assets and liabilities. The tax equivalent yield on interest-earning assets increased by 33 and 62 basis points during the third quarter and first nine months of 2005, compared to the same periods in 2004, mainly due to the re-pricing of variable rate commercial and construction loans and the origination of new commercial and construction loans originated in a rising interest rate environment. The average rate paid by the Corporation on its interest-bearing liabilities increased by 111 basis points and 90 basis points during third quarter and first nine months of 2005 when compared to same periods in 2004, mainly due to re-pricing of the Corporation s interest bearing deposits, principally time deposits, FHLB advances, and other borrowed funds.

The increase in short term rates resulted in a decrease in the net payments received on interest rate swaps included as part of interest expenses. For the third quarter and nine months ended September 30, 2006, the net settlement payments received on such interest rate swaps resulted in a benefit of $\$ 16.4$ million and $\$ 61.5$ million, respectively, compared to $\$ 32.7$ million and $\$ 94.7$ million, respectively, for the same periods in 2004.

## Provision and 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 adequacy of the allowance for loan and lease losses is also based upon a number of additional factors including historical loan 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 the Corporation believes that the allowance for loan and lease losses is adequate, factors beyond the Corporation s control, including factors affecting the Puerto Rico, Florida (USA), US Virgin Islands and British Virgin Islands economies may contribute to delinquencies and defaults, thus necessitating additional reserves.

For the quarter and nine month period ended September 30, 2006, the Corporation provided $\$ 20.6$ million and $\$ 49.3$ million, respectively, for loan and lease losses, as compared to $\$ 12.9$ million and $\$ 34.9$ million, respectively, for the same periods in 2005, and $\$ 13.2$ million and $\$ 39.6$ million, respectively, for the same periods in 2004.

Refer to the discussion under Credit Risk Management below for analysis of the allowance for loan and lease losses and non-performing assets and related ratios.
2006 compared to 2005. First BanCorp s provision for loan and lease losses for the third quarter and first nine months of 2006 increased by $\$ 7.7$ million or $60 \%$ and $\$ 14.4$ million or $41 \%$, respectively, compared to the same periods in 2005. The increase in the provision was mainly due to increasing trends in non-accruing loans and net charge-offs experienced during 2006. At September 30, 2006, the Corporation s non-accruing loans amounted to $\$ 231.8$ million, an increase of $\$ 110.7$ million compared to non-accruing loans outstanding at September 30, 2005. The increase was mainly due to increases in delinquency of the residential real estate and commercial loan portfolios. The Corporation s trends in non-accruing loans were affected by the fiscal and economic situation of Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico is currently in a midst of a recession. The

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latest GNP forecast by the Puerto Rico Planning Board expects a $1.4 \%$ reduction in fiscal year 2007 compared to fiscal year 2006. 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.

Net charge-offs for the third quarter and first nine months of 2006 were $\$ 16.2$ million and $\$ 46.4$ million, respectively ( $0.60 \%$ and $0.51 \%$, respectively, of average loans on an annualized basis), as compared to $\$ 11.7$ million and $\$ 30.0$ million, respectively ( $0.39 \%$ and $0.36 \%$, respectively, of average loans), for the comparable periods in 2005. The increase in net charge-offs for 2006, compared to 2005, was mainly associated with the auto loans portfolio, driven by increased delinquency levels experienced during 2006. Recoveries made from previously written-off accounts were $\$ 5.1$ million and $\$ 8.1$ million for the third quarter and first nine months of 2006, respectively, compared to $\$ 1.4$ million and $\$ 4.8$ million for the same periods in 2005, respectively. The Corporation s net charge-offs were also affected by the deteriorating economic condition in Puerto Rico.
2005 compared to 2004. For the third quarter and first nine months of 2005, the Corporation s provision for loan and lease losses decreased by $\$ 0.3$ million, or $3 \%$, and $\$ 4.7$ million, or $12 \%$, respectively, compared to the same periods in 2004. The Corporation determined that, based on an analysis of the credit quality and change in the mix of its loan portfolio as the proportion of loans collateralized by residential real estate (including secured commercial loans to local financial institutions) to total loans increased during 2005, a smaller provision was required during 2005, compared to 2004, to maintain its loan and lease loss reserves at level adequate to absorb probable losses in the portfolio. The decrease in the provision during 2005 periods was also associated with the seasoning of the corporate commercial loan portfolios. The Corporation has not incurred significant losses as a percentage of its commercial loans receivable since it started emphasizing the corporate commercial lending activities in the late 1990s, therefore, the provision for inherent losses in this portfolio decreased.

Net charge-offs for the third quarter and first nine months of 2005 were $\$ 11.7$ million and $\$ 30.0$ million, respectively ( $0.39 \%$ and $0.36 \%$, respectively, of average loans on an annualized basis), as compared to $\$ 9.6$ million and $\$ 28.7$ million ( $0.47 \%$ and $0.50 \%$, respectively, of average loans) for the comparable periods in 2004. The increase in net charge-offs in 2005 compared to 2004 was mainly due to the growth of the portfolio. Recoveries made from previously written-off accounts were $\$ 1.4$ million and $\$ 4.8$ million in the third quarter and first nine months of 2005, respectively, compared to $\$ 1.5$ million and $\$ 4.4$ million for the same periods in 2004, respectively.

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Non-Interest Income

|  | 2006 |  | Quarter ended <br> September 30, |  |  |  | Nine Month Period Ended September 30, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | 2006 |  | 2005 |  | 2004 <br> (As <br> Restated) |  |
|  |  |  |  |  |  |  |  |  |
| (In thousands) |  |  |  |  |  |  |  |  |
| Other service charges on |  |  |  |  |  |  |  |  |  |  |  |  |
| loans | \$ | 1,228 |  |  | \$ | 1,529 |  |  | \$ | 852 | \$ | 4,181 | \$ | 4,188 | \$ | 2,957 |
| Service charges on deposit |  |  |  |  |  |  |  |  |  |  |  |  |
| Mortgage banking |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| activities Rental income |  | 1,595 |  | 318 875 |  | 1,329 814 |  | 1,447 |  | 3,888 2,584 |  | 3,091 2,133 |
| Insurance income |  | 2,650 |  | 2,282 |  | 1,712 |  | 8,519 |  | 6,476 |  | 4,688 |
| Other operating income |  | 3,720 |  | 4,968 |  | 3,484 |  | 10,130 |  | 12,173 |  | 11,545 |

Non-interest income
before net (loss) gain on investments, gain (loss) on partial extinguishment of secured commercial loan to local financial institution and gain on sale of credit card portfolio

13,175
11,332
37,714
38,513
34,393
Net gain on sale of investments
Impairment on investments

4,518
$3,003 \quad 5,431 \quad 14,349$
7,575

| 3,056 | 4,518 | 3,003 | 5,431 | 14,349 | 7,575 |
| :---: | :---: | :---: | :---: | :---: | :---: |
| $(9,139)$ |  | $(2,643)$ | $(12,089)$ | $(1,499)$ | $(2,699)$ |

Net (loss) gain on investments
$(6,083) \quad 4,518$
360
$(6,658) \quad 12,850$
4,876
Gain (loss) on partial extinguishment of secured commercial loan to local financial institution

$$
1,000
$$

$(10,640)$
Gain on sale of credit card portfolio

Total
$\$ 8,045 \quad \$ 17,693 \quad \$ \quad 11,692 \quad \$ 20,416 \quad \$ 51,363 \quad \$ \quad 44,802$

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 on mortgage banking activities; net gains and losses on investments and impairments; and gains or losses on derivatives that are designated non-economic hedges ( non-economic derivatives ).

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 the 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.

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.

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

The other operating income category is composed of miscellaneous fees such as debit and credit card interchange fees and check fees. Other operating income also includes unrealized gains and losses on certain non-economic derivatives.

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.

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2006 compared to 2005. First BanCorp s non-interest income for the third quarter and first nine months of 2006 decreased by $\$ 9.6$ million, or $55 \%$, and $\$ 30.9$ million, or $60 \%$, respectively, compared to the same periods in 2005. The decrease in non-interest income for the third quarter of 2006, compared to the third quarter of 2005, was mainly due to other-than-temporary impairment charges recognized in the Corporation s available-for-sale portfolio and lower gains on sales of investments partially offset by higher earnings in the Corporation s mortgage banking and insurance activities.

The decrease in non-interest income for the first nine months of 2006, compared to the first nine months of 2005, was primarily due to a net loss of $\$ 10.6$ million recognized on the partial extinguishment of a secured commercial loan to a local financial institution, higher other-than-temporary impairment charges recognized in the Corporation s available for sale portfolio, lower gains on sales of investments, and lower earnings in the Corporation s mortgage banking activities partially offset by increases in insurance income and other commissions and fees.

For the third quarter and first nine months of 2006, the Corporation recorded a net loss on investment securities of $\$ 6.1$ million and $\$ 6.7$ million, respectively, compared to a gain of $\$ 4.5$ million and $\$ 12.9$ million, respectively, for the comparable periods in 2005. The net loss on investment securities recorded in 2006, compared to 2005, was principally attributable to other-than-temporary impairment charges related to certain equity securities held in the Corporation s available-for-sale portfolio coupled with a lower volume of sales. For the third quarter and first nine months of 2006, other-than-temporary impairments amounted to $\$ 9.1$ million and $\$ 12.1$ million. For the first nine months of 2005 other-than-temporary impairments on available for sale securities amounted to $\$ 1.5$ million; no impairment charges were recognized during the third quarter of 2005.

Non-interest income results for the first nine months of 2006 were significantly impacted by a net loss of $\$ 10.6$ million recorded on the partial extinguishment of a secured commercial loan extended to a local financial institution. On May 25, 2006, the Corporation entered into a series of credit agreements with Doral Financial Corporation (Doral ) to formally document as secured borrowings the loan transfers between the parties that previously had been accounted for 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 its secured commercial loan to approximately $\$ 450.0$ million as of such 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 incurs as part of the sales of the mortgages that 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 will be reduced proportionately to the extent that Doral does not sell the mortgages. As a result of the sharing agreement and the reduction in the secured commercial loan by Doral, for the nine month period ended September 30, 2006, the Corporation recorded a net loss of $\$ 10.6$ million composed of gains and losses as part of the sharing agreement and the difference between the carrying value of the loans and the net payment received from Doral.

Mortgage banking activities for the third quarter of 2006 resulted in income of $\$ 1.6$ million compared to a $\$ 0.3$ million for the third quarter of 2005. The increase for the third quarter of 2006, compared to the same period in 2005, was primarily due to a higher volume of sales of mortgage loans in the secondary market. For the first nine months of 2006, income from mortgage banking activities decreased by $\$ 2.4$ million compared to the same period in 2005. The decrease for the first nine months of 2006, compared to the same period in 2005, was mainly due to a lower volume of mortgage loan sales coupled with 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

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rates. During 2005, the Corporation entered into an arrangement with an unrelated financial institution (the Counterparty ) in which, in substance, the parties agreed to sell and purchase similar mortgage loan portfolios. Pursuant to this arrangement, the Corporation purchased mortgage loans with an aggregate unpaid principal balance of $\$ 87.2$ million for $\$ 88.9$ million in March 2005. In April and May of 2005, the Corporation sold to the Counterparty mortgage loans with aggregate unpaid principal balances of $\$ 60.0$ million and $\$ 29.7$ million, for $\$ 61.1$ million and $\$ 30.3$ million, respectively, resulting in gains on the sales of $\$ 1.3$ million and $\$ 0.6$ million, respectively. Since the Corporation retained the servicing on the mortgage loans sold to the Counterparty, it also recognized a servicing asset of $\$ 1.2$ million during the second quarter of 2005. The Corporation entered into these transactions because, among other reasons, they were consistent with its business objectives of developing a mortgage-banking business that would provide liquidity as well as developing new sources for the acquisition of mortgage loans. Notwithstanding that the transactions were in substance the purchase and sale of similar mortgage loan portfolios, generally accepted accounting principles require that the transactions be treated as a separate purchase and a separate sale.

Insurance income for the third quarter and first nine months of 2006 increased by $\$ 0.4$ million or $16 \%$ and $\$ 2.0$ million or $32 \%$, respectively, compared to the corresponding periods in 2005 . The increase for 2006 was due to an increase in volume of business through cross-selling strategies, marketing efforts and the strategic locations of the Corporation s insurance offices.

Other commissions and fees for the first nine months of 2006 increased by $\$ 0.9$ million compared to the same period in 2005. The increase in other commissions and fees was due to consulting services provided by the Corporation to the Government Development Bank for Puerto Rico for the issuance of certain financial instruments during the second quarter of 2006.
2005 compared to 2004. First BanCorp s non-interest income for the third quarter and first nine months of 2005 increased by $\$ 6.0$ million and $\$ 6.6$ million, respectively, compared to the same periods in 2004. The increase in non-interest income during 2005 was principally due to higher net gains on investments, insurance income, and service charges on deposit accounts and loans partially offset by a decrease in other commissions and fees income. Comparative results were also affected by the sale of a credit card portfolio during 2004. The Corporation recorded a gain of $\$ 5.5$ million on the sale of a credit card portfolio during the first nine months of 2004 pursuant to a strategic alliance agreement reached with a U.S. financial institution in 2003. During 2005, the Corporation did not enter into such transactions.

For the third quarter and first nine months of 2005, the Corporation s net gain on investment securities increased by $\$ 4.2$ million and $\$ 8.0$ million, respectively, compared to the same periods in 2004. The increase in net gains on investment securities in 2005, compared to 2004, was principally attributable to a higher volume of sales and lower other-than-temporary impairment charges recognized during 2005.

Insurance income for the third quarter and first nine months of 2005 increased by $\$ 0.6$ million or $33 \%$ and $\$ 1.8$ million or $38 \%$, respectively, compared to the corresponding periods in 2004. The increase for 2005 was due to an increase in 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 loans for the third quarter and first nine months of 2005 increased by $\$ 1.0$ million or $28 \%$ and $\$ 1.7$ million or $16 \%$ compared to the same periods in 2004. The increase for 2005 primarily reflects a larger volume of accounts and transactions due to growth in the Corporation s different lines of business as compared to 2004.

Income from mortgage banking activities during the third quarter of 2005 decreased by $\$ 1.0$ million compared to the same period in 2004. The decrease in income from mortgage banking activities for 2005 primarily reflects a lower volume of sales of mortgage loans in the secondary market. For the first nine months of 2005,

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mortgage banking activities resulted in income of $\$ 3.9$ million, an increase of $\$ 0.8$ million or $26 \%$ compared to results for the first nine months of 2004. The increase for the first nine months of 2005 was primarily due to a higher volume of loan sales. As discussed above, during 2005, the Corporation entered into an arrangement with another unrelated financial institution in which, in substance, the parties agreed to sell and purchase similar mortgage loan portfolios. As a result of transactions derived from this agreement the Corporation recognized a gain on sales of mortgage loans of approximately $\$ 1.9$ million during the second quarter of 2005. Since the Corporation retained the servicing on the mortgage loans sold in these transactions, it also recognized a servicing asset of $\$ 1.2$ million.

Other commissions and fees for the third quarter and first nine months of 2005 decreased by $\$ 0.3$ million and $\$ 1.3$ million, respectively, compared to the same periods in 2004. The decrease during 2005 principally reflects lower fees as a result of a reduced volume of consulting services. During 2004, the Corporation provided consulting services to the Government Development Bank for Puerto Rico for the issuance of certain financial instruments.

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## Non-Interest Expenses

The following table presents the detail of non-interest expenses for the periods indicated:

|  |  | Quarter ended September 30, |  |  | Nine Month Period Ended September 30, |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | $\begin{gathered} 2004 \\ \text { (As } \end{gathered}$ |  |  | 2006 |  | 2005 | 2004 <br> (As <br> Restated) |  |
| (In thousands) | 2006 | 2005 | Restated) |  |  |  |  |  |  |
| Employees compensation and benefits | \$ 32,881 | \$ 26,839 | \$ | 21.153 | \$ | 96,876 | \$ 76,427 | \$ | 62,127 |
| Occupancy and equipment | 13,730 | 12,843 |  | 10,260 |  | 40,060 | 35,248 |  | 29,080 |
| Deposit insurance premium | 412 | 329 |  | 233 |  | 1,201 | 882 |  | 726 |
| Other taxes, insurance and supervisory fees | 5,028 | 3,420 |  | 3,045 |  | 12,963 | 9,612 |  | 8,537 |
| Professional service fees | 7,408 | 3,553 |  | 1,024 |  | 24,944 | 6,961 |  | 2,964 |
| Servicing and processing fees | 1,682 | 1,796 |  | 323 |  | 5,634 | 4,841 |  | 1,544 |
| Business promotion | 4,513 | 4,876 |  | 4,354 |  | 12,611 | 14,509 |  | 12,411 |
| Communications | 2,293 | 2,071 |  | 1,938 |  | 6,761 | 6,145 |  | 5,493 |
| Other | 4,993 | 4,828 |  | 3,547 |  | 14,668 | 15,010 |  | 11,310 |
| Total | \$ 72,940 | \$ 60,555 | \$ | 45,877 |  | 215,718 | \$ 169,635 | \$ | 134,192 |

2006 compared to 2005. The Corporation s non-interest expenses for the third quarter and first nine months of 2006 increased by $\$ 12.4$ million, or $20 \%$, and $\$ 46.1$ million, or $27 \%$, respectively, compared to the same periods in 2005. The increase in non-interest expenses for 2006 was mainly due to increases in professional fees, employees compensation and benefits, other taxes, insurance and supervisory fees, and occupancy and equipment expenses partially offset by a decrease in business promotion expenses. The increase in non-interest expenses for 2006 also includes an increase of $\$ 6.2$ million associated with the operations of Ponce General Corporation acquired in March 2005. The results for Ponce General Corporation in 2006 reflect three quarters of activity compared to two quarters for 2005.

Employees compensation and benefits expenses for the third quarter and first nine months of 2006 increased by $\$ 6.0$ million, or $23 \%$, and $\$ 20.4$ million, or $27 \%$, respectively, compared to the same periods in 2005 . A significant portion of the increase was associated with the expensing of the fair value of stock options granted to certain employees following the provisions of SFAS 123R. The Corporation recorded $\$ 0.5$ million and $\$ 5.4$ million during the third quarter and first nine months of 2006, respectively, in stock-based compensation expenses. The increase in compensation and benefits expenses was also attributable to increases in the average compensation and related fringe benefits paid to employees and an increase in the employees headcount as of September 30, 2006. The increase in the headcount was mostly attributable to increases associated with the Corporation s loan origination and deposit gathering efforts, in particular in FirstBank Puerto Rico, FirstBank Florida, FirstMortgage Inc. ( First Mortgage ), and the Corporation s small loan company, First Federal Finance, as well as increases in support areas, in particular audit and compliance, credit risk management, finance and accounting, information technology and banking operations. In addition, compensation and benefits expense for the first nine months of 2006 increased due to the acquisition of Ponce General Corporation in March 31, 2005. For the third quarter and first nine months of 2006, compensation and benefits expense associated with the operation in Florida increased by $\$ 0.8$ million and $\$ 3.0$ million, respectively, compared to the same periods in 2005.

Professional service fees increased during the third quarter and first nine months of 2006 by $\$ 3.9$ million and $\$ 18.0$ million, respectively, compared to the same periods in 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, the restatement process and other related legal and regulatory proceedings which increased professional fees by $\$ 2.5$ million and $\$ 13.0$ million for the third quarter and first nine months of 2006, respectively, compared to the same periods in 2005.

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Other taxes, insurance and supervisory fees for the third quarter and first nine months of 2006 increased by $\$ 1.6$ million and $\$ 3.4$ million, respectively, compared to the same periods in 2005. During 2006, the Corporation experienced increased insurance costs mainly related to increases in rates and coverage of directors and officers liability insurance and expensed a higher amount of municipal and property taxes during 2006 as compared to 2005.

Occupancy and equipment expenses for the third quarter and first nine months of 2006 increased by $\$ 0.9$ million, or $7 \%$, and $\$ 4.8$ million, or $14 \%$, respectively, compared to the same periods in 2005 . The increase in occupancy and equipment expenses in 2006 as compared to 2005 is mainly 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, security costs and additional costs associated with the operations of Ponce General Corporation.

Business promotion expenses decreased during the third quarter and first nine months of 2006 by $\$ 0.4$ million, or $7 \%$, and $\$ 1.9$ million, or $13 \%$, respectively, compared to the same periods in 2005 . The decrease was due to the Corporation s decision to reduce its marketing expenditures.
2005 compared to 2004. The Corporation s non-interest expenses for the third quarter and first nine months of 2005 increased by $\$ 14.7$ million or $32 \%$ and $\$ 35.4$ million or $26 \%$, respectively, compared to the same periods in 2004. The increase in non-interest expenses for 2005 mainly reflects increases in employees compensation and benefits, occupancy and equipment expenses, professional fees, and servicing and processing fees.

Employees compensation and benefits expenses increased during the third quarter and first nine months of 2005 by $\$ 5.7$ million or $27 \%$ and $\$ 14.3$ million or $23 \%$, respectively, compared to the same periods in 2004 . The increase in compensation and benefits expenses was primarily attributable to increases in the average compensation and related fringe benefits paid to employees and increase in the employees headcount for 2005. The increase in the headcount was mainly to support the growth in operations, and in particular to support new products and services, including First Mortgage and FirstBank Florida operations.

Occupancy and equipment expenses increased during the third quarter and first nine months of 2005 by $\$ 2.6$ million or $25 \%$ and $\$ 6.2$ million or $21 \%$, compared to the same periods in 2004. The increase is mainly attributable to increases in costs associated with the expansion of the Corporation s branch network and loan origination offices.

Professional service fees increased during the third quarter and first nine months of 2005 by $\$ 2.5$ million and $\$ 4.0$ million, respectively, compared to the same periods in 2004. The increase was mainly due to higher expenses related with Sarbanes-Oxley Act compliance and to legal, accounting and consulting fees associated with the internal review conducted by the Corporation s Audit Committee, the restatement process and other related legal and regulatory proceedings.

Servicing and processing fees expenses increased during the third quarter and first nine months of 2005 by $\$ 1.5$ million and $\$ 3.3$ million, respectively, compared to the same periods in 2004. Reduced non-interest expenses during the first nine months of 2004 were due primarily to the strategic alliance agreement and sale of the Corporation s credit card portfolio to a U.S. financial institution in 2003. As part of the agreement, the Corporation entered into a service level agreement to temporarily service the credit card portfolio that the U.S. financial institution acquired. During the third quarter and first nine months of 2004, the Corporation was reimbursed $\$ 1.1$ million and $\$ 3.1$ million, respectively, in expenses for services provided under the service level agreement.

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## Provision for Income Tax

Income tax expense include Puerto Rico and Virgin Islands income taxes as well as applicable 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 US 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. The additional tax related to the income earned from January 1 to the date of enactment of the law was recorded in the third quarter of 2005. 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 doing business through international banking units ( IBEs ) of the Corporation and the Bank and by the Bank s subsidiary FirstBank Overseas Corporation. 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; such limitations were 30\% of total net taxable income for a taxable year commencing between July 1, 2004 and July 1, 2005 , and $20 \%$ of total net taxable income for taxable years commencing thereafter.
2006 compared to 2005. For the third quarter of 2006, the Corporation s income tax expense amounted to $\$ 10.6$ million, compared to a net income tax benefit of $\$ 6.3$ million recognized for the same period in 2005. The fluctuation in the provision for income tax for the third quarter of 2006, compared to 2005, was mainly due to a reduction in deferred income tax benefits, coupled with an increase in the current tax provision. For the third quarter of 2006, the Corporation recognized a deferred income tax benefit of $\$ 9.1$ million compared to a deferred income tax benefit of $\$ 24.7$ million for the same period in 2005. The lower deferred income tax benefit for 2006 was mainly due to unrealized gains on derivative instruments caused by changes in long-term interest rates.

For the nine month period ended September 30, 2006, the Corporation recognized an income tax expense of $\$ 14.8$ million, compared to $\$ 32.0$ million for the same period in 2005. The decrease in income tax expense was mainly due to a decrease in deferred income tax benefits, as a result of fluctuations in the fair value of derivatives instruments. For the first nine months of 2006, the Corporation recognized a deferred income tax benefit of $\$ 35.6$ million, compared to $\$ 17.9$ million for the same period in 2005.

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At September 30, 2006, 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. At September 30, 2006, the deferred tax asset, net of the valuation allowance of $\$ 4.9$ million, amounted to approximately $\$ 170.9$ million compared to $\$ 93.3$ million at September 30, 2005. At September 30, 2005, based on the Corporation s analysis and available evidence, the Corporation did not establish a valuation allowance.
2005 compared to 2004. For the third quarter of 2005, the Corporation recognized a net income tax benefit of $\$ 6.3$ million compared to an income tax expense of $\$ 34.8$ million for the same period in 2004. The fluctuation in the income tax provision for 2005, compared to 2004, was mainly attributable to changes in the Corporation s deferred income tax, partly offset by increases in the provision for current income tax. For the third quarter of 2005, the Corporation recognized a deferred income tax benefit of $\$ 24.7$ million compared to a deferred income tax expense of $\$ 23.3$ million for the same period in 2004. The fluctuation in deferred income tax was mainly due to valuation adjustments to the Corporation s derivative instruments due to changes in long-term interest rates. The current provision for income taxes for the third quarter of 2005 increased by $\$ 6.9$ million compared to the same quarter in 2004. The increase in the current income tax provision was mainly due to changes in the proportion of exempt and taxable income as a result of increases in the Corporation staxable income generated from the Corporation s loan portfolios and decreases in tax exempt income mainly from the Corporation s investment portfolios.

For the first nine months of 2005, the Corporation s provision for income tax decreased by $\$ 7.8$ million compared to the same period in 2004. The decrease in income tax expense was mainly due to a decrease in deferred income tax, as a result of fluctuations on the valuation adjustments of derivatives instruments. For the first nine months of 2005, the Corporation recognized a deferred income tax benefit of $\$ 17.9$ million compared to a deferred income tax expense of $\$ 0.2$ million for the same period in 2004.

## FINANCIAL CONDITION AND OPERATING DATA ANALYSIS

## Loan Production

First BanCorp relies primarily on its retail network of branches to originate residential and consumer loans. The Corporation supplements its residential mortgage loan originations with wholesale servicing released mortgage loan purchases from small mortgage bankers. The Corporation manages its construction and commercial loan originations through a centralized unit and most of its originations come from existing customers as well as through referrals and direct solicitations. For commercial loan originations, the Corporation also has regional offices to provide services to designated territories. For purposes of the following table, the Corporation separately presented commercial loans to local financial institutions because it believes this approach provides a better representation of the Corporation s commercial loan production capacity.

Total loan production for the quarter and nine month period ended September 30, 2006 were $\$ 965.6$ million and $\$ 3.6$ billion, respectively, compared to $\$ 1.4$ billion and $\$ 4.9$ billion, respectively, for the comparable periods in 2005, and $\$ 1.3$ billion and $\$ 3.5$ billion, respectively, for the comparable periods in 2004. The decrease in loan production during 2006, compared to 2005, was due mainly due to decreases in originations of residential real estate, commercial loan, and consumer loan originations mainly due to higher interest rates, worsening economic conditions in Puerto Rico, and stricter underwriting guidelines.

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The following table sets the First BanCorp s loan production for the periods indicated:

|  | Quarter ended September 30, |  |  |  | Nine month period ended September 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2006 | 2005 | 2004 |  | 2006 | 2005 | 2004 <br> (As <br> Restated) |  |
|  |  |  |  | (As |  |  |  |  |
|  |  |  |  | Restated) |  |  |  |  |
| (In thousands) |  |  |  |  |  |  |  |  |
| Residential real estate | \$ 203,301 | \$ 399,186 | \$ | 209,945 | \$ 720,706 | \$ 987,784 | \$ | 562,987 |
| Commercial and |  |  |  |  |  |  |  |  |
| Construction | 537,459 | 681,086 |  | 287,738 | 2,187,491 | 2,372,286 |  | 892,889 |
| Finance Leases | 43,526 | 35,645 |  | 30,176 | 133,386 | 103,829 |  | 85,503 |
| Consumer | 181,341 | 262,018 |  | 185,363 | 584,022 | 752,654 |  | 530,942 |
|  | 965,627 | 1,377,935 |  | 713,222 | 3,625,605 | 4,216,553 |  | 2,072,321 |
| Commercial loans to local financial |  |  |  |  |  |  |  |  |
| institutions |  |  |  | 540,820 |  | 681,407 |  | 1,403,500 |
| Total loan production | \$ 965,627 | \$ 1,377,935 | \$ | 1,254,042 | \$ 3,625,605 | \$ 4,897,960 | \$ | 3,475,821 |

## Residential Real Estate Loans

Residential mortgage loan production for the third quarter and first nine months of 2006 amounted to $\$ 203.3$ million and $\$ 720.7$ million, respectively, compared to $\$ 399.2$ million and $\$ 987.8$ million, respectively, for the same periods in 2005, and $\$ 209.9$ million and $\$ 563.0$ million, respectively, for the same periods in 2004 . The decrease in mortgage loan production for 2006, compared to 2005, was mainly attributable to higher prevailing interest rates, deteriorating economic conditions in Puerto Rico 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 the worsening economic conditions in Puerto Rico. The implementation of these standards contributed to the reduction in the Corporation s mortgage loan originations.

Residential real estate loans represent $20 \%$ of total loans originated and purchased for the first nine months of 2006. The Corporation s strategy is to penetrate markets by providing customers with a variety of high quality mortgage products. The Corporation s originations of residential mortgage loans continued to be driven by FirstMortgage, its mortgage loan origination subsidiary. The Corporation continues 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. 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 and small mortgage bankers 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 them, and to assist real estate brokers in building their individual businesses and closing transactions. FirstMortgage multi-channel strategy has proven to be effective in capturing business.

## Commercial and Construction Loans

Commercial and construction loan production for the third quarter and first nine months of 2006 amounted to $\$ 537.5$ million and $\$ 2.2$ billion, respectively, compared to $\$ 681.1$ million and $\$ 2.4$ billion, respectively, for the same period in 2005, and $\$ 287.7$ million and $\$ 892.9$ million, respectively, for the same periods in 2004 . The decrease in 2006 compared to 2005 was mainly due to adverse economic conditions in Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico is in a midst of a recession, causing a slowdown in commercial business activity. The increase in commercial and construction loan production for 2005 compared to 2004 was driven by the Corporation s subsidiary bank loan agency in Coral Gables, Florida. The Corporation s Coral Gable operation started in

October 2004. Loans originated by the agency for the third quarter and first nine months of 2005 amounted to $\$ 214.4$ million and $\$ 493.3$ million, respectively.

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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 up to $\$ 5$ million. The Corporation established 4 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.

## Consumer Loans

Consumer loan originations are principally driven through the Corporation s retail network. Consumer loan production for the third quarter and first nine months of 2006 amounted to $\$ 181.3$ million and $\$ 584.0$ million, respectively, compared to $\$ 262.0$ million and $\$ 752.7$ million, respectively, for the same periods in 2005 , and $\$ 185.4$ million and $\$ 530.9$ million, respectively, for the same periods in 2004. The decrease in consumer loan originations for 2006 compared to 2005 was mainly due to adverse economic conditions in Puerto Rico. The increase when compared to 2004 was primarily due to increases in auto loan originations. Auto loan originations come primarily through referrals from the Corporation $s$ network of auto dealers.

## Finance Leases

During the third quarter and first nine months of 2006, finance lease originations, which are mostly composed of loans to individuals to finance the acquisition of a motor vehicle, increased by $\$ 7.9$ million and $\$ 29.6$ million, respectively, compared to the same periods in 2005, and increased by $\$ 13.4$ million and $\$ 47.9$ million, respectively, when compared to the same periods in 2004.

## Assets

Total assets at September 30, 2006 amounted to $\$ 17.4$ billion, a decrease of $\$ 2.5$ billion and $\$ 1.9$ billion compared to total assets at December 31, 2005 and September 30, 2005, respectively, and an increase of $\$ 2.2$ billion compared to total assets at September 30, 2004. The decrease in total assets at September 30, 2006 compared to total assets at December 31, 2005 was mainly the result of a decrease in total loans of $\$ 1.8$ billion and a decrease of $\$ 719.1$ million in total investments including money market instruments. The decrease in the Corporation sloans portfolio was due to the payment of $\$ 2.4$ billion received from a local financial institution to reduce its secured commercial loan with the Corporation. During the second half of 2006, the Corporation used a substantial amount of the proceeds to repay outstanding brokered CDs that matured during the third and fourth quarter of 2006.

The decrease in the investment portfolio resulted mainly from prepayments and maturities received from the Corporation s investment portfolio, mainly mortgage-backed securities and the Corporation s decision to deleverage its investment portfolio. The deleverage of the investment portfolio was influenced, among other things, by the flat to inverted yield curve. As a result, the Corporation decided to repay higher rate maturing liabilities, in particular brokered CDs, rather than investing the proceeds at an effective interest rate lower than the Corporation s cost of funds.

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## Loan Portfolio

The composition of the Corporation s loans portfolio for the periods indicated is as follows:


At September 30, 2006, the Corporation s total loans decreased by $\$ 1.8$ billion and $\$ 1.5$ billion, when compared with balances as of December 31, 2005 and September 30, 2005, respectively, and increased by $\$ 2.3$ billion when compared to the balance as of September 30, 2004. The decrease in the Corporation stotal loans receivable primarily relates to the partial extinguishment of a secured commercial loan partially offset by a growth in the Corporation s other portfolios through new originations, net of repayments. Refer to the Loan Production section of this discussion above for further details on the Corporation s originations by product.

## Residential Real Estate Loans

As of September 30, 2006, the Corporation s residential real estate loan portfolio increased by $\$ 347.2$ million, $\$ 594.2$ million and $\$ 1.5$ billion as compared to balances as of December 31, 2005, September 30, 2005, and September 30, 2004, respectively. The Corporation has diversified its loan receivable portfolio by increasing the concentration of residential real estate loans. The residential real estate loans as a percentage of total loans has increased over time from 14\% at September 30, 2004 to 25\% at September 30, 2006.

## Commercial and Construction Loans

As of September 30, 2006, the Corporation s commercial loan portfolio decreased by $\$ 2.3$ billion compared to balances as of December 31, 2005 and September 30, 2005 and increased by $\$ 131.6$ million compared to the balance at September 30, 2004. The decrease was mainly due to a payment received of $\$ 2.4$ billion that substantially reduced the Corporation s secured commercial loan extended to a local financial institution. The Corporation strategy focuses on growing its commercial loans portfolio principally through commercial real estate and construction loans. A substantial portion of this portfolio is collateralized by real estate. The Corporation s commercial loans are primarily variable- and adjustable-rate loans.

The Corporation had a lending concentration of $\$ 433.2$ million in one mortgage originator in Puerto Rico, Doral, at September 30, 2006. The Corporation had outstanding $\$ 527.8$ million with another mortgage originator in Puerto Rico, R\&G, for total loans to mortgage originators amounting to $\$ 961.0$ million at

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September 30, 2006. These commercial loans are secured by individual mortgage loans on residential and commercial real estate. The mortgage originators have always paid the loans in accordance with their terms and conditions. In December 2005, the Corporation obtained a waiver from the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico ( Office of the Commissioner ) with respect to the statutory limit for individual borrowers (loans-to-one borrower limit). In May 2006, the Corporation received a cash payment from Doral of approximately $\$ 2.4$ billion, substantially reducing the balance of the secured commercial loan to that institution. As part of the Cease and Desist Order imposed on the Corporation by its regulators, the Corporation has continued working on the reduction of its exposure to Doral.

During the fourth quarter of 2005, First BanCorp received a partial payment from R\&G of $\$ 137$ million for its secured commercial loans. In addition, in February 2007, the Corporation entered into various agreements with R\&G relating to prior transactions originally treated as purchases of mortgages 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 approximately $\$ 271$ million was re-documented as a secured loan from the Corporation to R\&G. Second, R\&G and the Corporation amended various agreements involving approximately $\$ 218$ 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. For further detail, refer to the Corporation s Current Report on Form 8-K filed with the SEC on February 16, 2007. The execution of the agreements 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 that First BanCorp recharacterized for accounting and legal purposes as commercial loans secured by the mortgage loans and pass-through trust certificates.

## Consumer Loans

As of September 30, 2006, the Corporation s consumer loans portfolio increased by $\$ 56.8$ million, $\$ 105.9$ million, and $\$ 498.4$ million as compared to the portfolio balances at December 31, 2005, September 30, 2005, and September 30, 2004, respectively. The increase is mainly driven by increases in the Corporation s auto loan portfolio. 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.

The above-mentioned 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.

## Finance Leases

As of September 30, 2006, finance leases, which are mostly composed of loans to individuals to finance the acquisition of a motor vehicle, increased by $\$ 63.8$ million, $\$ 85.7$ million and $\$ 146.1$ million as compared to portfolio balances as of December 31, 2005, September 30, 2005, and September 30, 2004, respectively. These leases typically have five-year terms and are collateralized by a security interest in the underlying assets. The Corporation s credit risk exposure for this portfolio is similar to the credit exposure of an auto loan (extended to individuals) portfolio.

## Investment Activities

As part of its strategy to diversify its revenue sources and maximize its net interest income, First BanCorp maintains an investment portfolio that is classified as available-for-sale or held-to-maturity. The Corporation s investment portfolio at September 30, 2006 amounted to $\$ 5.1$ billion, a decrease of $\$ 293.6$ million,

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an increase of $\$ 4.4$ million, and a decrease of $\$ 61.6$ million when compared with the investment portfolio at December 31, 2005, September 30, 2005, and September 30, 2004, respectively. The decrease in investment securities at September 30, 2006, compared to balances at December 31, 2005, was due to the Corporation s decision to deleverage its balance sheet by not reinvesting maturities and prepayments received from the Corporation s investment portfolio, mainly mortgage-backed securities. The Corporation $s$ decision to deleverage its investment portfolio was influenced, among other things, by the flat-to-inverted yield curve. As a result, the Corporation decided to repay during the second half of 2006 higher rate maturing liabilities, in particular brokered CDs, rather than investing the proceeds at an interest yield lower than the Corporation $s$ cost of funds.

The following table presents the carrying value of investments at the indicated dates:

|  |  |  | September |  |
| :--- | :---: | :---: | :---: | :---: |
|  | September | December | September | 30, |
|  | 30, | $\mathbf{3 1 ,}$ | $\mathbf{3 0 ,}$ | $\mathbf{2 0 0 4}$ |
| (As |  |  |  |  |

Mortgage-backed securities at the indicated dates consist of:

|  |  | September |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  |  | 30, |  |
|  | September | December | September |  |
| (In thousands) | 30, | 31, | 30, | 2004 |
|  | 2006 | 2005 | 2005 |  |



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The carrying values of investment securities (excluding other equity securities) at September 30, 2006, by contractual maturity (excluding mortgage-backed securities, equity securities and money market investments) are shown below:

| (Dollars in thousands) | Carrying amount | Weighted average yield \% |
| :---: | :---: | :---: |
| US Government and agencies obligations |  |  |
| Due within one year | \$ 156,913 | 4.96 |
| Due after five years through ten years | 392,621 | 4.31 |
| Due after ten years | 2,079,363 | 5.83 |
|  | 2,628,897 | 5.55 |
| PR Government obligations |  |  |
| Due after one year through five years | 4,773 | 6.17 |
| Due after five years through ten years | 31,838 | 5.37 |
| Due after ten years | 20,289 | 5.60 |
|  | 56,900 | 5.52 |
| Corporate bonds |  |  |
| Due after five years through ten years | 1,124 | 7.46 |
| Due after ten years | 5,676 | 7.04 |
|  | 6,800 | 7.11 |
|  | 2,692,597 | 5.55 |
| Mortgage-backed securities | 2,401,767 | 4.81 |
| Equity securities | 20,220 | 0.80 |
| Total investment securities available-for-sale and held-to-maturity | \$ 5,114,584 | 5.18 |

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 substantial investments in callable securities. 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 market interest rate fluctuations. Refer to the Risk Management discussion below 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.
Sources of Funds

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

As of September 30, 2006, total liabilities amounted to $\$ 16.2$ billion, a decrease of $\$ 2.6$ billion and $\$ 1.9$ billion as compared to balances as of December 31, 2005 and September 30, 2005, respectively, and an increase of $\$ 2.2$ billion compared to balances as of September 30, 2004. The decrease in total liabilities during 2006, compared to 2005, was mainly attributable to brokered CDs coupled with decreases in FHLB advances, federal funds purchased and securities sold under repurchase agreements. The payment of $\$ 2.4$ billion received from a local financial institution was used to pay down the aforementioned liabilities. The Corporation s decision to pay down maturing liabilities, in particular brokered CDs, was influenced, among other things, by the flat to inverted yield curve. As result, the Corporation decided to repay higher rate maturing liabilities, in particular brokered CDs, rather than investing the proceeds at an interest yield lower than the Corporation s cost of funds.

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Total liabilities increased in 2005, compared to 2004, mainly due to increases in interest bearing deposits, mainly brokered CDs, partially offset by decreases in FHLB advances and federal funds purchased and securities sold under repurchase agreements. 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, as financial institutions are at a competitive disadvantage since the income generated on other investment products available to investors in Puerto Rico has been taxed at lower rates than tax rates for income generated on deposit products. The brokered CDs market is very competitive and liquid and the Corporation has been able to obtain substantial amounts of funding in short periods of time. This strategy enhances 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 by entering into interest rate swap agreements.

CDs with denominations of $\$ 100,000$ or higher, including brokered CDs, amounted to $\$ 9.0$ billion at September 30, 2006. At September 30, 2006, brokered CDs amounted to $\$ 8.1$ billion. Brokered CDs are sold by third-party intermediaries in denominations of $\$ 100,000$ or less. The following table presents a maturity schedule of brokered CDs at September 30, 2006:

Three months or less
Over three months to six months
Over six months to one year
Over one year to five years
Over five years
Total
\$ 8,148,566

The Corporation maintains unsecured lines of credit with other banks. At September 30, 2006, the Corporation s total unused lines of credit with these banks amounted to $\$ 335.0$ million. At September 30, 2006, the Corporation had an available line of credit with the FHLB, guaranteed with excess collateral in the amount of $\$ 546.8$ million.

The Corporation s deposit products include regular savings accounts, demand deposit accounts, money market accounts, CDs, and brokered CDs. Refer to Note11 Deposits in the accompanying notes to unaudited interim consolidated financial statements for further details. Total deposits amounted to $\$ 11.9$ billion at September 30, 2006, compared to $\$ 12.5$ billion, $\$ 12.3$ billion and $\$ 7.4$ billion at December 31, 2005, September 30, 2005 and 2004, respectively. The decrease in total deposits for 2006, compared to 2005, was mainly due to decreases in brokered CDs.

Refer to the Net Interest Income discussion above for information about average balances of interest-bearing deposits, and the average interest rate paid on deposits for the quarters and nine month periods ended September 30, 2006, 2005 and 2004.

## Capital

The Corporation s stockholders equity amounted to $\$ 1.22$ billion at September 30, 2006, $\$ 1.20$ billion at December 31, 2005, $\$ 1.25$ billion at September 30, 2005, and $\$ 1.17$ billion at September 30, 2004. Total capital increased by $\$ 26.7$ million compared to total capital at December 31, 2005 and decreased by $\$ 30.2$ million compared to total capital at September 30, 2005. The change in capital for 2006 is mainly composed of earnings of $\$ 62.3$ million, the issuance of $2,379,000$ shares of common stock through the exercise of stock options with proceeds of $\$ 19.8$ million offset in part by cash dividends of $\$ 47.7$ million and by unrealized losses in the Corporation s securities available-for-sale portfolio of $\$ 13.1$ million.

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On August 1, 2007 the United States District Court for the District of Puerto Rico issued a Preliminary Order approving the stipulation of settlement filed in connection with the proposed settlement of the class action lawsuit brought on behalf of First BanCorp s shareholders against the Corporation in the amount of $\$ 74.25$ million. The effectiveness of a final order to be issued by the Court is subject to:

- The payment of $\$ 61$ million to be deposited by First BanCorp in a settlement fund within fifteen calendar days of the date of issuance of the Preliminary Order; and
- The mailing of a notice to shareholders that describes the general terms of the settlement.

The court hearing for the final order of approval of the settlement has been set for October 15, 2007. First BanCorp intends to comply with the $\$ 61$ million payment requirement within the timeframe set forth in the terms of the settlement. The remaining amount of $\$ 13,250,000$ will be paid before December 31, 2007. The monetary payment will have no impact on the Corporation s earnings or capital in 2007. As reflected in First BanCorp s audited Consolidated Financial Statements, included in the Corporation s 2005 Annual Report on Form 10-K, the Corporation accrued $\$ 74.25$ million in 2005 for a possible settlement of the class action.

On August 7, 2007, First BanCorp announced that the SEC approved a final settlement with the Corporation, which resolves the previously disclosed SEC investigation of the Corporation. Under the settlement, 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 pay 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 will have 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 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.

During the first quarter of 2007, the Corporation agreed to issue, subject to regulatory approval, approximately 9.250 million shares of its common stock to The Bank of Nova Scotia ( Scotiabank ), through a private placement offering, valuing the stock at $\$ 10.25$ per share for a total purchase price of approximately $\$ 94.8$ million. The valuation reflects a premium of approximately $5 \%$ over the volume weighted- average closing share price over the 30 trading-day period that ended January 30, 2007. After the investment, Scotiabank will hold approximately $10 \%$ of First BanCorp s currently outstanding common shares. The original agreement provided that the agreement may be terminated at any time prior to the closing by either the Corporation or Scotiabank if the closing did not occur by July 31, 2007 (the Termination Date ). The agreement was subsequently amended to change the Termination Date to August 31, 2007. On August 9, 2007, First BanCorp announced the approval by the Federal Reserve Board of the private placement offering with Scotiabank.

On March 17, 2006, First BanCorp and its banking subsidiary FirstBank entered into consent orders with the Board of Governors of the Federal Reserve System, the FDIC and the Office of the Commissioner relating to mortgage-related transactions with Doral and R\&G. For additional description of these orders, please refer to Current Report on Form 8-K filed with the SEC on March 20, 2006.

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Effective January 1, 2007, the Corporation early adopted the provision of SFAS 157 and SFAS 159. Refer to Note 2 of the accompanying unaudited consolidated financial statement for additional information. Regulatory capital increased by the positive adjustment to retained earnings recognized as part of the adoption of SFAS 159, exceeding by higher margins the capital levels required to be classified as well-capitalized and strengthening the Corporation s current regulatory capital ratios.

As of September 30, 2006, First BanCorp, FirstBank Puerto Rico and FirstBank Florida were in compliance with the 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 September 30, 2006, based on existing Federal Reserve, Federal Deposit Insurance Corporation and the Office of Thrift Supervision guidelines.

| Banking subsidiaries |  |  |
| :---: | :---: | :---: |
|  | FirstBank | To be well |
|  | Florida | capitalized |
| nk | $11.17 \%$ | $10.00 \%$ |
| $\%$ | $10.81 \%$ | $6.00 \%$ |
| $\%$ | $8.04 \%$ | $5.00 \%$ |

## REGULATORY CAPITAL RATIOS

Total Capital (Total capital to risk-weighted assets)
Tier 1 Capital Ratio (Tier I capital to risk-weighted assets)
Leverage Ratio (1)
(1) Tier 1 capital to
average assets
in the case of
First BanCorp
and First Bank
and Tier 1
capital to
adjusted total
assets in the
case of First
Bank Florida.

## Dividends

During the first nine months of 2006 and 2005, the Corporation declared cash dividends of $\$ 0.21$, per common share representing a $16.7 \%$ increase over the aggregate cash dividend of $\$ 0.18$ per common share declared for the same period in 2004. Total cash dividends paid on common shares amounted to $\$ 17.5$ million for the nine-month period ended September 30, 2006 (or a $54 \%$ dividend payout ratio), $\$ 17.0$ million for the same period in 2005 (or a $15 \%$ dividend payout ratio) and $\$ 14.5$ million for the corresponding 2004 period (or a $14 \%$ dividend payout ratio). Dividends declared on preferred stock amounted to approximately $\$ 30.2$ million for each of the nine month periods ended on September 30, 2006, 2005, and 2004.

## 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 scredit, market or liquidity risks, (3) diversify the Corporation sfunding sources and (4) optimize capital.

As a provider of financial services, the Corporation routinely commits to financial instruments with off-balance sheet risk to meet the financial needs of its customers. These financial instruments 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 statements of financial position. At September 30, 2006, commitments to extend credit and commercial and financial standby letters of credit amounted to approximately $\$ 1.9$ billion and $\$ 100.8$ 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.

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## Contractual Obligations and Commitments

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

## Contractual Obligations and Commitments September 30, 2006

(In thousands)

|  | Total |  | Less than 1 year |  | $1-3$ years | 3-5 years | After 5 years |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Contractual obligations: |  |  |  |  |  |  |  |  |
| Certificates of deposit | \$ | 9,852,049 | \$ | 4,791,044 | \$ 1,112,184 | \$ 199,913 | \$ | 3,748,908 |
| Federal funds purchased and securities sold under |  |  |  |  |  |  |  |  |
| agreements to repurchase |  | 3,228,435 |  | 1,690,935 | 250,000 | 487,500 |  | 800,000 |
| Advances from FHLB |  | 134,000 |  | 5,000 | 129,000 |  |  |  |
| Notes payable |  | 181,575 |  |  |  | 7,675 |  | 173,900 |
| Other borrowings |  | 231,695 |  |  |  |  |  | 231,695 |
| Total contractual obligations |  | 13,627,754 | \$ | 6,486,979 | \$ 1,491,184 | \$ 695,088 | \$ | 4,954,503 |

Commitments to sell mortgage loans

Standby letters of credit

Commitments to extend credit:
Lines of credit
Letters of credit
Commitments to originate loans
\$ 1,277,320 \$ 1,277,320
78,150 78,150
526,045 526,045
Total commercial commitments \$ 1,881,515 \$ 1,881,515
The Corporation has obligations and commitments to make future payments under contracts, such as outstanding debt securities, 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. 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. In the ordinary course of business, the Corporation enters into operating leases and other commercial commitments. There have been no significant changes in such contractual obligation since the end of 2005.

## RISK MANAGEMENT

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, (2) market risk, (3) credit risk, (4) liquidity risk, (5) operational risk, (6) legal and compliance risk, (7) reputation risk, and (8) contingency risk. First BanCorp has adopted policies and procedures which have been designed to
identify and manage risks to which the Corporation is exposed, specifically those relating to interest rate risk, credit risk, liquidity risk, and operational 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 FirstBank

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( 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 Risk Manager of the Treasury and Investment Department, the Economist 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 uses scenario analysis to measure the effects of changes in interest rates on net interest income. These simulations are carried out over a one-year and a two-year time horizon, assuming gradual upward and downward interest rate movements of 200 basis points. 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 in order to simplify the projections. 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 prepayment rates, and other factors which may be important in projecting the future growth of net interest income. These projections are carried out for First BanCorp on a fully consolidated basis.

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. Interest rates used for the simulations also correspond to actual rates at the start of the projection period.

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. There have been no significant changes in the Corporation s interest rate risk profile since the end of 2005.
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 derivatives 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 CDs (liabilities) 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

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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.
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.

The following table summarizes the notional amount of all derivative instruments as of September 30, 2006, December 31, 2005, September 30, 2005, and September 30, 2004:

## Notional amounts

|  | As of September 30, 2006 | $\begin{gathered} \text { As of } \\ \text { December } \\ 31, \\ 2005 \\ \text { (Dollars } \end{gathered}$ | As of September 30, 2005 thousands) | As of September 30, 2004 (As Restated) |
| :---: | :---: | :---: | :---: | :---: |
| Interest rate swap agreements: Pay fixed versus receive floating | \$ 80,720 | \$ 109,320 | \$ 109,320 | \$ 113,165 |
| Received fixed versus pay floating | 4,858,490 | 5,751,128 | 5,748,120 | 3,867,766 |
| Embedded written options | 13,515 | 13,515 | 13,515 | 13,515 |
| Purchased options | 13,515 | 13,515 | 13,515 | 13,515 |
| Written interest rate cap agreements | 125,200 | 150,200 | 150,200 | 25,000 |
| Purchased interest rate caps | 338,617 | 386,750 | 556,052 | 25,000 |
|  | \$ 5,430,057 | \$ 6,424,428 | \$ 6,590,722 | \$ 4,057,961 |

The following table summarizes the notional amount of all derivatives by the Corporation s designation as of September 30, 2006, December 31, 2005, September 30, 2005 and September 30, 2004:

## Notional amounts

|  | As of September 30, 2006 | As of December 31, <br> 2005 (Dollar | As of September 30, 2005 housands) | As of September 30, 2004 (As <br> Restated) |
| :---: | :---: | :---: | :---: | :---: |
| Designated hedges: <br> Fair value hedge: |  |  |  |  |
| Interest rate swaps used to hedge fixed rate certificates of deposit Interest rate swaps used to hedge fixed and step rate notes payable | \$ 4,321,746 165,442 | \$ | \$ | \$ |
| Total fair value hedges | \$ 4,487,188 | \$ | \$ | \$ |
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Economic undesignated hedges:

| Interest rate swaps used to hedge fixed rate certificates of deposit and loans | \$ | 452,022 | \$ 5,860,448 | \$ | 5,857,440 | \$ | 3,980,931 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Embedded options on stock index deposits |  | 13,515 | 13,515 |  | 13,515 |  | 13,515 |
| Purchased options used to manage exposure to the stock market on embedded stock index options |  | 13,515 | 13,515 |  | 13,515 |  | 13,515 |
| Written interest rate cap agreements |  | 125,200 | 150,200 |  | 150,200 |  | 25,000 |
| Purchased interest rate cap agreements |  | 338,617 | 386,750 |  | 556,052 |  | 25,000 |
| Total derivatives not designated as hedge | \$ | 942,869 | \$ 6,424,428 | \$ | 6,590,722 | \$ | 4,057,961 |
| Total |  | ,430,057 | \$ 6,424,428 | \$ | 6,590,722 | \$ | 4,057,961 |

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The following tables summarize the fair value changes of the Corporation $s$ derivatives as well as the source of the fair values:
(In thousands)
Fair value of contracts outstanding at the beginning of the period
Contracts realized or otherwise settled during the period
Changes in fair value during the period

Prior to April 2006, none of the derivative instruments held by the Corporation were 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 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 values of the derivatives do not offset the changes in fair values of the hedged liabilities due to changes in the hedged risks. Prior to the implementation of fair value hedge accounting, the Corporation recorded unrealized losses in the valuation of interest rate swaps of approximately $\$ 68.0$ million during the first quarter of 2006.

With the implementation of the long-haul method with respect to the brokered CDs and medium-term notes on April 3, 2006, the basis differential between the market value and book value of the hedged liabilities at the inception of fair value hedge accounting, of approximately $\$ 200.0$ million, amortizes or accretes as a yield adjustment over the remaining term of the hedged liabilities. For the quarter and nine month period ended September 30, 2006, the Corporation recorded an accretion of $\$ 0.8$ million and an amortization of $\$ 0.4$ million, respectively, as a basis adjustment.

Effective January 1, 2007, the Corporation decided to early adopt SFAS 159 for the callable brokered CDs and the callable 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 is 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 $63 \%$ of the brokered CDs portfolio and for certain medium-term notes. The CDs and Notes chosen for the fair value measurement option are the ones hedged at January 1, 2007 by callable interest rate swaps with the same terms and conditions. The adoption of SFAS 159 also resulted on a positive after-tax impact to retained earnings of approximately $\$ 92.2$ million. Under SFAS 159, this one-time credit will not be recognized in current earnings.

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 derivatives contracts based on changes in interest rates. The credit risk of derivatives arises from the potential of a 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. 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.

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## 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 represent 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 loans. Refer to Contractual Obligations and Commitments above for further details. The credit risk of derivatives arises from the potential of a 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, and quality control. 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, 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.

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

## 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 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 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 Puerto Rico, the state of Florida, US VI or British VI economies may contribute to delinquencies and defaults, thus necessitating additional reserves.

For small, homogeneous loans, including residential mortgage loans, auto loans, consumer loans, finance lease loans, and commercial and construction loans under $\$ 1.0$ million, the Corporation evaluates a specific allowance based on average historical loss experience for each corresponding type of loans. The methodology of accounting for all probable losses is made in accordance with the guidance provided by Statement of Accounting Standards No. 5,
Accounting for Contingencies.
Commercial and construction loans in amounts of over $\$ 1.0$ million are individually evaluated on a quarterly basis for impairment following the provisions of SFAS No. 114, Accounting by Creditors for Impairment of a

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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.

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

| (In thousands) |  | Quarter ended September 30, |  |  | Nine Month Period Ended September 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2006 | 2005 |  | $\begin{gathered} 2004 \\ \text { (As } \\ \text { Restated) } \end{gathered}$ | 2006 | 2005 |  | $\begin{gathered} 2004 \\ \text { (As } \\ \text { Restated) } \end{gathered}$ |
| Allowance for loan and lease losses, |  |  |  |  |  |  |  |  |
| beginning of period | \$ 146,527 | \$ 146,154 | \$ | 133,678 | \$ 147,999 | \$ 141,036 | \$ | 126,378 |
| Provision for loan and lease losses | 20,560 | 12,861 |  | 13,200 | 49,290 | 34,890 |  | 39,600 |
| Loans charged off: |  |  |  |  |  |  |  |  |
| Residential real estate | (171) | (311) |  | (57) | (871) | $(1,053)$ |  | (142) |
| Commercial and |  |  |  |  |  |  |  |  |
| Construction | $(1,550)$ | $(2,610)$ |  | $(1,609)$ | $(4,561)$ | $(5,906)$ |  | $(4,930)$ |
| Finance leases | $(1,530)$ | (787) |  | $(1,185)$ | $(3,246)$ | $(1,626)$ |  | $(2,498)$ |
| Consumer | $(17,982)$ | $(9,489)$ |  | $(8,253)$ | $(45,816)$ | $(26,209)$ |  | $(25,511)$ |
| Recoveries | 5,071 | 1,449 |  | 1,479 | 8,130 | 4,772 |  | 4,356 |
| Net charge-offs | $(16,162)$ | $(11,748)$ |  | $(9,625)$ | $(46,364)$ | $(30,022)$ |  | $(28,725)$ |
| Other adjustments |  |  |  |  |  | 1,363 |  |  |
| Allowance for loan and lease losses, end of period | \$ 150,925 | \$ 147,267 | \$ | 137,253 | \$ 150,925 | \$ 147,267 | \$ | 137,253 |
| Allowance for loan and lease losses to period end total loans |  |  |  |  |  |  |  |  |
| Net charge-offs annualized to average |  |  |  |  |  |  |  |  |
| loans outstanding during the period | 0.60\% | 0.39\% |  | 0.47\% | 0.51\% | 0.36\% |  | 0.50\% |
| Provision for loan and lease losses to net charge-offs during the |  |  |  |  |  |  |  |  |
| period | 1.27 x | 1.09x |  | 1.37 x | 1.06x | 1.16x |  | 1.38x |

First BanCorp s allowance for loan and lease losses was $\$ 150.9$ million at September 30, 2006, compared to $\$ 147.3$ million and $\$ 137.3$ million at September 30, 2005 and 2004, respectively. The provision for loan and lease
losses for the third quarter and first nine months of 2006 amounted to $\$ 20.6$ million and $\$ 49.3$ million, respectively, compared to $\$ 12.9$ million and $\$ 34.9$ million, respectively, for the corresponding periods in 2005 and $\$ 13.2$ million and $\$ 39.6$ million, respectively, for the corresponding periods in 2004. The increase in this provision for 2006, compared to 2005, was principally due to the growth in the Corporation s commercial (other than secured commercial loans to local financial institutions) and consumer loan portfolios coupled with increasing trends in non-performing loans and charge-offs experienced during 2006 as compared to 2005 reflecting deteriorating economic conditions in Puerto Rico. The Corporation s net charge-offs were affected by the fiscal and economic situation of Puerto Rico. According to the Puerto Rico Planning Board, Puerto Rico is currently in a midst of a recession since March 2006. The latest Gross National Product forecast by the Puerto Rico Planning Board expects a $1.4 \%$ reduction in fiscal year 2007 compared to fiscal year 2006. 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. The decrease in the provision during 2005 as compared to 2004 was primarily attributable to the seasoning of the corporate commercial loans portfolio.

First BanCorp s ratio of the allowance for loan and lease losses to period end total loans receivable increased by 19 basis points at September 30, 2006 compared to September 30, 2005 and decreased by 39 basis points at September 30, 2005 compared to September 30, 2004. The increase during 2006, compared to 2005,

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mainly reflects the increase in non-performing loans experienced during 2006. The decrease in the allowance during 2005 as compared to 2004 was mainly due to a change in the composition of the Corporation s loan portfolio (to higher concentration of residential real estate loans) and recent loss experience, specifically for commercial and residential real estate portfolio.

The Corporation s ratio of the provision for loan and lease losses to net charge-offs for the third quarter and first nine months of 2006 totaled $127 \%$ and $106 \%$, respectively, compared to $109 \%$ and $116 \%$, respectively, for the corresponding periods in 2005, and $137 \%$ and $138 \%$, respectively, for the corresponding periods in 2004 . The increase during the third quarter of 2006 compared to the same period in 2005 was mainly due to the aforementioned economic situation of Puerto Rico.
Non-accruing and Non-performing Assets
Total non-performing assets are the sum of non-accruing loans, foreclosed real estate and other repossessed properties. Non-accruing loans are loans as to which interest is no longer being recognized. When loans fall into non-accruing status, all previously accrued and uncollected interest is charged against interest income.
Non-accruing Loans Policy
Residential Real Estate Loans - The Corporation classifies real estate loans in non-accruing status when interest and principal have not been received for a period of 90 days or more.

Commercial Loans - The Corporation places commercial loans (including commercial real estate and construction loans) in non-accruing status when interest and principal have not been received in a period of 90 days or more. The risk exposure of this portfolio is diversified as to individual borrowers and industries among other factors. In addition, a large portion is secured with real estate collateral.

Finance Leases Finance leases are classified in non-accruing status when interest and principal have not been received for a period of 90 days or more.

Consumer Loans - Consumer loans are classified in non-accruing status when interest and principal have not been received for a period of 90 days or more.
Other Real Estate Owned (OREO)
OREO acquired in settlement of loans is carried at the lower of cost (carrying value of the loan) or fair value less estimated costs to sell the real estate at the date of acquisition (estimated realizable value).

## Other Repossessed Property

The other repossessed property category includes repossessed boats and autos acquired in settlement of loans. Repossessed boats and autos are recorded at the lower of cost or estimated fair value.

## Past Due Loans

Past due loans are accruing commercial loans, which are contractually delinquent for 90 days or more. Past due commercial loans are current as to interest but delinquent in the payment of principal.

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The following table presents non-performing assets at the dates indicated:

|  | September 30, |  | $\begin{aligned} & \text { December } \\ & \text { 31, } \end{aligned}$ |  | $\begin{aligned} & \text { September } \\ & \text { 30, } \end{aligned}$ |  | $\begin{aligned} & \text { September } \\ & \text { 30, } \end{aligned}$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | $\begin{gathered} 2004 \\ (\mathrm{As} \end{gathered}$ |  |  |  |
|  |  | 30, |  |  |  | 31, |
| (Dollars in thousands) | 2006 |  | 2005 |  |  |  | 2005 |  | Restated) |  |
| Non-accruing loans: |  |  |  |  |  |  |  |  |
| Residential real estate | \$ | 101,772 | \$ | 54,777 | \$ | 44,702 | \$ | 29,786 |
| Commercial, commercial real estate and construction |  | 79,740 |  | 35,814 |  | 32,792 |  | 36,349 |
| Finance leases |  | 7,458 |  | 3,272 |  | 2,896 |  | 1,960 |
| Consumer |  | 42,865 |  | 40,459 |  | 40,750 |  | 20,639 |
|  | 231,835 |  | 134,322 |  | 121,140 |  | 88,734 |  |
| Other real estate owned |  | 3,713 |  | 5,019 |  | 6,032 |  | 6,939 |
| Other repossessed property |  | 18,431 |  | 9,631 |  | 8,274 |  | 6,994 |
| Total non-performing assets | \$ | 253,979 | \$ | 148,972 | \$ | 135,446 | \$ | 102,667 |
| Past due loans | \$ | 35,676 | \$ | 27,501 | \$ | 34,414 | \$ | 21,980 |
| Non-performing assets to total assets |  | 1.46\% |  | 0.75\% |  | 0.70\% |  | 0.68\% |
| Non-accruing loans to total loans receivable |  | 2.13\% |  | 1.06\% |  | 0.99\% |  | 1.03\% |
| Allowance for loan and lease losses | \$ | 150,925 | \$ | 147,999 | \$ | 147,267 | \$ | 137,253 |
| Allowance to total non-accruing loans |  | 65\% |  | 110\% |  | 122\% |  | 155\% |
| Allowance to total non-accruing loans, excluding residential real estate loans |  | 116\% |  | 186\% |  | 193\% |  | 233\% |

Due to deteriorating economic conditions in Puerto Rico, increased delinquencies, and overall growth of the Corporation s loan portfolio, First BanCorp increased its allowance for loan and lease losses from $\$ 137.3$ million as of September 30, 2004 to $\$ 150.9$ million as of September 30, 2006.

As a result of the increase in delinquencies, the Corporation s non-accruing loans to total loans receivable ratio has increased over time from $1.03 \%$ at September 30, 2004 to $2.13 \%$ at September 30, 2006. The increase was mainly due to increases in non-accruing loans in the residential real estate portfolio and, to a lesser extent, increases in commercial and consumer portfolios. Historically, the Corporation has experienced the lowest rates of losses for its residential real estate portfolio. As a consequence, the provision and allowance for loan and lease losses did not increase proportionately with the increase in non-accruing loans. In addition, the Corporation s allowance for loan and lease losses allocated to the commercial portfolio has decreased due to the stability, recent loss experience and aging of the portfolio. As a consequence, at September 30, 2006, the Corporation s ratio of the allowance for loan and lease losses to non-performing loans decreased by 90 basis points from $155 \%$ as of September 30, 2004 to $65 \%$ as of September 30, 2006. Excluding residential real estate loans, the ratio of the allowance for loan and lease losses to non-accruing loans decreased by 117 basis points from 233\% at September 30, 2004 to $116 \%$ at September 30, 2006.

The increase in consumer non-accrual loans mainly relates to increases in the Corporation auto and unsecured personal loan portfolios.

## Liquidity Risk Management

Liquidity refers to the level of cash and eligible investments to meet loan and investment commitments, potential deposit outflows and debt repayments. MIALCO, using measures of liquidity developed by management, which involves the use of several assumptions, reviews the Corporation s liquidity position on a weekly basis.

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The Corporation utilizes different sources of funding to help ensure that adequate levels of liquidity are available when needed. Diversification of funding sources is of great importance as it protects the Corporation s liquidity from market disruptions. The principal sources of short-term funds are deposits, securities sold under agreements to repurchase, and lines of credit with the FHLB as well as other unsecured lines established with financial institutions. MIALCO reviews credit availability on a regular basis. In the past, the Corporation has securitized and sold auto and mortgage loans as supplementary sources of funding. Additional funding is provided by the sale of commercial paper as well as long-term funding through the issuance of notes and long-term brokered CDs. The cost of these different alternatives, among other things, is taken into consideration. The Corporation sprincipal uses of funds are the origination of loans and the repayment of maturing deposit accounts and borrowings.

A large portion of the Corporation s funding is retail brokered CDs issued by the banking subsidiaries. In the event that the Corporation s bank subsidiaries are not well-capitalized institutions, they might not be to replace this source of funding. The banking subsidiaries currently comply with the minimum requirements ratios for well-capitalized institutions and the Corporation does not foresee any risks to their ability to issue brokered deposits. In addition, the average life of the retail brokered CDs was approximately 6.3 years at September 30, 2006. Approximately $56 \%$ of these certificates are callable, but only at the Corporation soption.

Refer to the Sources of Funds section above for further details on the Corporation s brokered CDs. Operational Risk

The Corporation faces ongoing and emerging risk and regulatory pressures related to the activities that surround the delivery of banking and financial products. Coupled with external influences such as market conditions, security risks, and legal risk, its potential for operational and reputational loss has increased. In order to mitigate and control operational risk, the Corporation has developed, and continues to enhance, specific internal controls, policies and procedures that are designated to identify and manage operational risk at appropriate levels throughout the organization. The purpose of these mechanisms is to provide reasonable assurance that the Corporation s business operations are functioning within the policies and limits established by management.

The Corporation classifies operational risk into two major categories: business specific and corporate-wide affecting all business lines. For business specific risks, a risk assessment group works with the various business units to ensure consistency in policies, processes and assessments. With respect to corporate wide risks, such as information security, business recovery, legal and compliance, the Corporation has specialized groups, such as the Legal Department, Information Security, Corporate Compliance, Information Technology and Operations. These groups assist the lines of business in the development and implementation of risk management practices specific to the needs of the business groups.

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

For information regarding market risk to which the Corporation is exposed, see the information contained under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Management.

## ITEM 4. CONTROLS AND PROCEDURES

## Disclosure Control and Procedures

First BanCorp s management, with the participation of its Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of First BanCorp s disclosure controls and procedures as of September 30, 2006. Disclosure controls and procedures are defined under SEC rules as controls and other procedures that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within required time periods. Disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to the issuer s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. As a result of this evaluation, First BanCorp s Chief Executive Officer and its Chief Financial Officer have concluded that the Company s disclosure controls and procedures were effective as of September 30, 2006.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by management or employees in the normal course of their assigned functions.

As reported in the Corporation s 2005 Annual Report on Form 10-K dated February 9, 2007, management previously concluded that its internal control over financial reporting was not effective as of December 31, 2005. Such conclusion resulted from the identification of the following material weaknesses:

1. Ineffective Control Environment.
2. Ineffective controls over the documentation and communication of relevant terms of certain mortgage loans bulk purchase transactions.
3. Ineffective controls over communications to the Audit Committee.
4. Ineffective controls over communication to the Corporation s independent registered public accounting firm.
5. Ineffective anti-fraud controls and procedures.
6. Insufficient accounting resources and expertise.
7. Ineffective controls over the accounting for mortgage-related transactions.
8. Ineffective controls over the accounting for derivative financial instruments.
9. Ineffective controls over the valuation of premiums and discounts on mortgage-backed securities.

These material weaknesses are discussed in greater detail in our Annual Report on Form 10-K for the year ended December 31, 2005.

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## Internal Control over Financial Reporting

During the first, second and third quarter of 2006, First BanCorp completed the implementation of remediation steps to fully remediate all material weaknesses referred to above.

During the first quarter of 2006, First BanCorp completed the implementation of the following remediation steps to fully remediate the material weakness number 9 Ineffective controls over the valuation of premiums and discounts on mortgage-backed securities as of March 31, 2006. The remediation steps taken by management were to adjust the balances to reflect the use of the effective interest method. In addition, the Corporation reviewed the accounting policy to require the use of the interest method for the amortization of premiums and discounts on mortgage-backed securities. As a result of such review, effective January 1, 2006, the Corporation implemented the interest method for the amortization of premiums and discounts on mortgage-backed securities.

During the second quarter of 2006, First BanCorp completed the implementation of the following remediation steps to fully remediate the material weaknesses number 7 and 8:

Ineffective controls over the accounting for mortgage-related transactions. The Corporation's management believes that, as of June 30, 2006, the Corporation has fully remediated the material weakness in its internal control over financial reporting with respect to purchases of mortgages in bulk and the purchases of mortgages where the seller of the mortgages retains the servicing responsibilities. The Corporation has implemented controls that specify that the terms of any recourse provisions or retained servicing arrangements must be reviewed by the General Counsel before they are included in purchase agreements. In addition, the Board has reviewed the Corporation's risk management program and enhanced the communication to the Audit Committee.

Ineffective controls over the accounting for derivative financial instruments. The Corporation's management believes that, as of June 30, 2006, the Corporation has fully remediated the material weakness in its internal control over financial reporting with respect to the identification of derivatives and the measurement of hedge effectiveness. With respect to the identification of derivatives, the Corporation has implemented the following changes:

The Corporation created the Investment and Derivative Risk Manager Position, which is responsible for the evaluation of complex transactions, such as derivatives, implementation of policies and procedures and monitoring of external consultants analyses/computations.

The legal and accounting departments must review any new forms of transactions or any variants of forms of transactions for which the Corporation has not determined the accounting in order to identify any derivatives resulting from the structure of such transactions.

Periodic testing of the hedge effectiveness process is required to make sure that it is operating effectively to ensure compliance with SFAS 133.

Education of personnel on derivative financial instruments and involvement of outside experts, as necessary.
With respect to the measurement of hedge effectiveness, the Corporation has revised its control accounting procedures to state that the receipt of an upfront payment from an interest rate swap counterparty precludes the use of the short-cut method of accounting under SFAS 133.

During the third quarter of 2006, First BanCorp completed the implementation of remediation steps to fully remediate the material weaknesses number 1 through 6 , which significantly improved its control environment including the documentation and communication of relevant terms of certain mortgage loan bulk purchase transactions, communication to the Audit Committee and to the Corporation's independent registered public accounting firm, anti-fraud controls and procedures, and accounting resources and expertise by implementing enhanced procedures and controls including the following:

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Changes in Management and Clarification of the Role, Responsibilities and Authority of Management. In addition to the previous appointments of a new CEO and COO, the Board appointed in February 15, 2006 a new General Counsel, who reports to the CEO, and a new CFO during the third quarter of 2006. The roles, responsibilities and authority of the persons in each of these positions have been clarified to better inhibit any override of the Corporation s internal control over financial reporting. In addition, in 2006 the Corporation implemented detection controls to improve the identification and response to any instances of undue control by an unauthorized person of the financial reporting process.

## Risk Management Program and Enhancement of the Communication of Information to the Audit

 Committee. During the first quarter of 2006, the Board reviewed the Corporation s risk management program with the assistance of outside consultants and legal counsel. This effort has resulted in a realignment of risk management functions and the adoption of an enterprise-wide risk management process. During the second quarter of 2006, the Board appointed a senior management officer as Chief Risk Officer and appointed this officer to the Risk Management Council with reporting responsibilities to the CEO and the Audit Committee. In addition, the Board formed an Asset/Liability Risk Committee which is responsible for the 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 investment activities 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 Committee has not yet reviewed to enable the 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 significant 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. The enhancements of the risk management program are expected to result in a control environment that ensures the discussion and analysis of the legal and accounting implications of new forms of transactions or variants of transactions that may have a significant impact on the Corporation $s$ financial condition or on the accuracy and completeness of the financial reporting process.Transaction Documentation. In August 2006, the Corporation adopted a specific policy that requires that all transactions be completely and fully documented, thereby prohibiting any oral or undisclosed side agreements, and that such documentation be contemporaneously prepared and executed and centrally maintained and organized.

Board Membership Changes. In addition to the previous appointments of the new CEO and new COO to the Board, in November 2005, the Board elected Fernando Rodriguez-Amaro as a new independent director to serve as an additional audit committee financial expert, and thereafter appointed him Chairman of the Audit Committee as of January 1, 2006. Also, in the first quarter of 2006, the Board appointed Jose Menendez Cortada as the Lead Independent Director of the Board.

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Corporate Governance Review. During the first quarter of 2006, with the assistance of outside consultants and outside counsel, the Corporate Governance Committee of the Board re-evaluated the Corporation s corporate governance policies and made recommendation to the full Board for changes. These changes were implemented and are expected to result in a continued and clearer understanding of the responsibilities and duties of the Board and its committees and in alignment of those responsibilities with the industry s best practices.

Ethical training of employees and directors. During the third quarter of 2006, the Corporation completed the offering of the corporate compliance seminars to every employee and director of the Corporation. Through the corporate compliance training program, the Corporation is emphasizing the importance of compliance with the Corporation spolicies and procedures and control systems, including the new policy regarding full and complete documentation of agreements and prohibiting oral and side agreements, the Corporation s Code of Ethics and Code of Conduct, the Corporation s various legal compliance programs, and the availability of mechanism to report possible unethical behavior, such as the Audit Committee s whistleblower hotline.

Procedures Relating to Concerns about Senior Management s Conduct. During 2006, the Board and the Audit Committee revised their respective procedures to emphasize more clearly the requirement that the Board or the Audit Committee be notified whenever any concerns arise regarding the conduct of senior management, including allegations of possible fraud, self-dealing or any other inappropriate conduct. In addition, when the Corporation appointed a new General Counsel, it specified that the General Counsel will report to the CEO in contrast to the former General Counsel who reported to the former CFO.

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Overall Accounting Resources and Expertise. The Corporation has recruited additional staff to strengthen its accounting, internal control, financial reporting, and internal audit functions. Further, the Corporation has appointed a senior management executive as the Chief Accounting Officer with primary responsibility for the development and implementation of the Corporation saccounting policies and practices and to review and monitor critical accounts and transactions to ensure that they are managed in accordance with such policies and practices, generally accepted accounting principles in the United States and applicable regulatory requirements.

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## PART II OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

The Corporation is subject to various legal proceedings arising as a result of the restatement of the Corporation s financial statements for the years 2004, 2003 and 2002. For information on these proceedings, please refer to Note 17 to the unaudited interim financial statements included in Item 1, Financial Statements, of this Quarterly Report on Form 10-Q.
ITEM 1A. RISK FACTORS
For a detailed discussion of certain risk factors that could affect First BanCorp s operations, financial condition or results for future periods see Item 1A, Risk Factors, in First BanCorp s 2005 Annual Report on Form 10-K.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.
ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
None.

## ITEM 5. OTHER INFORMATION

Not applicable.

## ITEM 6. EXHIBITS

31.1 CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Corporation has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized:

## First BanCorp.

Registrant

Date: August 20, 2007

Date: August 20, 2007

By: /s/ Luis M. Beauchamp<br>Luis M. Beauchamp<br>Chairman, President and Chief Executive Officer

By: /s/ Fernando Scherrer
Fernando Scherrer
Executive Vice President and Chief Financial Officer 104


[^0]:    (1) Represents
    allowance for
    loan losses from
    the acquisition

