

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

**Table of Contents**

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

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2007**

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

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

**COMMISSION FILE NUMBER 0-17224**

**FIRST BANCORP.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

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

66-0561882  
(I.R.S. employer  
identification number)

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

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(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the registrant is 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  Accelerated filer  Non-accelerated filer

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

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

Common stock: 92,504,056 outstanding as of August 31, 2007.

**FIRST BANCORP.  
INDEX PAGE**

|   | <b>PAGE</b> |
|---|-------------|
| <b>PART I. FINANCIAL INFORMATION</b>  |             |
| Item 1. Financial Statements:   |             |
| <u>Consolidated Statements of Financial Condition (Unaudited) as of March 31, 2007 and December 31, 2006</u>                  | 5           |
| <u>Consolidated Statements of Income (Unaudited) Quarters ended March 31, 2007 and March 31, 2006</u>                         | 6           |
| <u>Consolidated Statements of Cash Flows (Unaudited) Quarters ended March 31, 2007 and March 31, 2006</u>                     | 7           |
| <u>Consolidated Statements of Changes in Stockholders Equity (Unaudited) Quarters ended March 31, 2007 and March 31, 2006</u> | 8           |
| <u>Consolidated Statements of Comprehensive Income (Loss) (Unaudited) Quarters ended March 31, 2007 and March 31, 2006</u>    | 9           |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u>   | 10          |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                          | 37          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>   | 74          |
| <u>Item 4. Controls and Procedures</u>  | 74          |
| <b>PART II. OTHER INFORMATION</b>   |             |
| <u>Item 1. Legal Proceedings</u>  | 75          |
| <u>Item 1A. Risk Factors</u>  | 75          |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 75          |
| <u>Item 3. Defaults Upon Senior Securities</u>  | 75          |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u>  | 75          |
| <u>Item 5. Other Information</u>  | 75          |
| <u>Item 6. Exhibits</u>   | 75          |
| <b>SIGNATURES</b>   |             |
| <u>EX-31.1 SECTION 302, CERTIFICATION OF THE CEO</u>  |             |
| <u>EX-31.2 SECTION 302, CERTIFICATION OF THE CFO</u>  |             |
| <u>EX-32.1 SECTION 906, CERTIFICATION OF THE CEO</u>  |             |
| <u>EX-32.2 SECTION 906, CERTIFICATION OF THE CFO</u>  |             |

**Table of Contents**

**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 March 31, 2007 as a result of the delay in completing the restatement of the Corporation s audited financial statements for the years ended December 31, 2004, 2003 and 2002, and the unaudited selected quarterly financial information for each of the four quarters of 2004, 2003 and 2002, which resulted in delays in the filing of an amendment of First BanCorp s Annual Report on Form 10-K for the year ended December 31, 2004 and consequent delays in the filing of the Corporation s subsequent reports. For information regarding the restatement of First BanCorp s previously issued financial statements, see the Corporation s Amendment No. 1 to Annual Report on Form 10-K/A for the year ended December 31, 2004, which was filed with the SEC on September 26, 2006.

**FORWARD LOOKING STATEMENTS**

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

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

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

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

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

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

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

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

developments in technology;

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

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

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

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

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

**Table of Contents**

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 2006 Annual Report on Form 10-K and under Item 1A, Risk Factors, in this Quarterly Report on Form 10-Q.

**Table of Contents**

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

|  | <b>March 31, 2007</b> | <b>December 31,<br/>2006</b> |
|--|-----------------------|------------------------------|
| <b>Assets</b>  |                       |                              |
| Cash and due from banks  | \$ 132,665,435        | \$ 112,340,615               |
| Money market instruments   | 397,720,352           | 377,296,017                  |
| Federal funds sold and securities purchased under agreements to resell                                 | 38,432,597            | 42,051,281                   |
| Time deposits with other financial institutions  | 40,660,728            | 37,123,111                   |
| Total money market investments   | 476,813,677           | 456,470,409                  |
| Investment securities available for sale, at fair value:   |                       |                              |
| Securities pledged that can be repledged   | 1,212,754,083         | 1,373,466,630                |
| Other investment securities  | 615,737,650           | 326,956,340                  |
| Total investment securities available for sale   | 1,828,491,733         | 1,700,422,970                |
| Investment securities held to maturity, at amortized cost:   |                       |                              |
| Securities pledged that can be repledged   | 2,243,140,343         | 2,661,088,022                |
| Other investment securities  | 942,869,427           | 686,042,717                  |
| Total investment securities held to maturity, fair value of \$3,115,162,000 (2006 - \$3,256,965,610)   | 3,186,009,770         | 3,347,130,739                |
| Other equity securities  | 41,592,385            | 40,159,185                   |
| Loans, net of allowance for loan and lease losses of \$161,418,789 (December 31, 2006 - \$158,295,662) | 10,936,420,088        | 11,070,446,401               |
| Loans held for sale, at lower of cost or market  | 26,587,074            | 35,238,127                   |
| Total loans, net   | 10,963,007,162        | 11,105,684,528               |
| Premises and equipment, net  | 156,750,970           | 155,661,727                  |
| Other real estate owned  | 3,109,631             | 2,869,713                    |
| Accrued interest receivable on loans and investments   | 103,064,633           | 112,505,003                  |
| Due from customers on acceptances  | 948,651               | 149,716                      |
| Other assets   | 302,490,577           | 356,861,273                  |
| Total assets   | \$ 17,194,944,624     | \$ 17,390,255,878            |

**Liabilities & Stockholders Equity**

Liabilities:

Edgar Filing: FIRST BANCORP /PR/ - Form 10-Q

|  |                |                |
|--|----------------|----------------|
| Non-interest-bearing deposits  | \$ 711,202,952 | \$ 790,985,153 |
| Interest-bearing deposits (includes \$4,334,033,255 measured at fair value as of March 31, 2007) | 10,567,541,939 | 10,213,302,047 |
| Federal funds purchased and securities sold under agreements to repurchase                       | 3,163,303,500  | 3,687,724,000  |
| Advances from the Federal Home Loan Bank (FHLB)  | 590,000,000    | 560,000,000    |
| Notes payable (includes \$14,918,185 measured at fair value as of March 31, 2007)                | 182,635,713    | 182,827,572    |
| Other borrowings   | 231,743,418    | 231,719,406    |
| Bank acceptances outstanding   | 948,651        | 149,716        |
| Accounts payable and other liabilities   | 418,802,829    | 493,994,798    |
| Total liabilities  | 15,866,179,002 | 16,160,702,692 |

Commitments and contingencies (Note 16)

Stockholders' equity:

|   |                   |                   |
|---|-------------------|-------------------|
| Preferred stock, authorized 50,000,000 shares: issued and outstanding 22,004,000 shares at \$25 liquidation value per share | 550,100,000       | 550,100,000       |
| Common stock, \$1 par value, authorized 250,000,000 shares; issued 93,151,856 shares  | 93,151,856        | 93,151,856        |
| Less: Treasury stock (at par value)   | (9,897,800)       | (9,897,800)       |
| Common stock outstanding  | 83,254,056        | 83,254,056        |
| Additional paid-in capital  | 25,604,944        | 22,756,994        |
| Legal surplus   | 276,847,825       | 276,847,825       |
| Retained earnings   | 422,860,042       | 326,761,462       |
| Accumulated other comprehensive loss, net of tax benefit of \$196,577 (December 31, 2006 - \$221,389)                       | (29,901,245)      | (30,167,151)      |
| Total stockholders' equity  | 1,328,765,622     | 1,229,553,186     |
| Total liabilities and stockholders' equity  | \$ 17,194,944,624 | \$ 17,390,255,878 |

The accompanying notes are an integral part of these statements.



Table of Contents

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

|  | <b>Quarter Ended</b>      |                           |
|--|---------------------------|---------------------------|
|  | <b>March 31,<br/>2007</b> | <b>March 31,<br/>2006</b> |
| <b>Interest income:</b>  |                           |                           |
| Loans  | \$ 225,638,691            | \$ 246,089,307            |
| Investment securities  | 67,671,721                | 71,640,717                |
| Money market investments   | 5,274,070                 | 9,974,864                 |
| <br>Total interest income  | <br>298,584,482           | <br>327,704,888           |
| <br><b>Interest expense:</b>   |                           |                           |
| Deposits (Note 10)   | 124,089,525               | 186,838,073               |
| Federal funds purchased and repurchase agreements  | 41,770,029                | 53,565,529                |
| Advances from FHLB   | 8,197,241                 | 4,177,732                 |
| Notes payable and other borrowings   | 7,092,915                 | 10,304,945                |
| <br>Total interest expense   | <br>181,149,710           | <br>254,886,279           |
| <br>Net interest income  | <br>117,434,772           | <br>72,818,609            |
| <br><b>Provision for loan and lease losses</b>   | <br>24,914,468            | <br>19,375,887            |
| <br>Net interest income after provision for loan and lease losses  | <br>92,520,304            | <br>53,442,722            |
| <br><b>Non-interest income:</b>  |                           |                           |
| Other service charges on loans   | 1,791,092                 | 1,486,270                 |
| Service charges on deposit accounts  | 3,191,092                 | 3,277,029                 |
| Mortgage banking activities gain (loss)  | 762,071                   | (574,847)                 |
| Net loss on investments and impairments  | (2,158,691)               | (708,768)                 |
| Net gain on partial extinguishment and recharacterization of secured commercial loans to a local financial institution | 2,497,166                 |                           |
| Rental income  | 663,496                   | 773,290                   |
| Gain on sale of credit card portfolio  | 2,818,972                 |                           |
| Other operating income   | 6,257,122                 | 6,335,216                 |
| <br>Total non-interest income  | <br>15,822,320            | <br>10,588,190            |
| <br><b>Non-interest expenses:</b>  |                           |                           |
| Employees compensation and benefits  | 36,372,390                | 34,124,921                |
| Occupancy and equipment  | 14,382,408                | 12,706,090                |

Edgar Filing: FIRST BANCORP /PR/ - Form 10-Q

|  |                      |                       |
|--|----------------------|-----------------------|
| Business promotion   | 4,930,468            | 3,774,060             |
| Professional fees  | 6,396,518            | 7,392,966             |
| Taxes, other than income taxes                               | 3,581,335            | 2,555,269             |
| Insurance and supervisory fees                               | 1,691,740            | 1,701,012             |
| Other operating expenses                                     | 12,008,867           | 9,483,337             |
| <b>Total non-interest expenses</b>                           | <b>79,363,726</b>    | <b>71,737,655</b>     |
| <b>Income (loss) before income tax</b>                       | <b>28,978,898</b>    | <b>(7,706,743)</b>    |
| <b>Income tax (provision) benefit</b>                        | <b>(6,146,913)</b>   | <b>11,569,985</b>     |
| <b>Net income</b>  | <b>\$ 22,831,985</b> | <b>\$ 3,863,242</b>   |
| <b>Net income (loss) attributable to common stockholders</b> | <b>\$ 12,762,986</b> | <b>\$ (6,205,757)</b> |
| <b>Net income (loss) per common share:</b>                   |                      |                       |
| Basic  | \$ 0.15              | \$ (0.08)             |
| Diluted  | \$ 0.15              | \$ (0.08)             |
| <b>Dividends declared per common share</b>                   | <b>\$ 0.07</b>       | <b>\$ 0.07</b>        |

The accompanying notes are an integral part of these statements.

**Table of Contents**

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

|  | <b>Quarter Ended</b> |                  |
|--|----------------------|------------------|
|  | <b>March 31,</b>     | <b>March 31,</b> |
|  | <b>2007</b>          | <b>2006</b>      |
| <b>Cash flows from operating activities:</b>   |                      |                  |
| Net income   | \$ 22,831,985        | \$ 3,863,242     |
| Adjustments to reconcile net income to net cash provided by operating activities:                                      |                      |                  |
| Depreciation   | 4,361,547            | 4,112,001        |
| Amortization of core deposit intangible  | 842,695              | 932,041          |
| Provision for loan and lease losses  | 24,914,468           | 19,375,887       |
| Deferred income tax benefit  | (2,314,827)          | (28,644,913)     |
| Stock-based compensation recognized  | 2,847,950            | 4,892,360        |
| Loss (gain) on sale of investments, net  | 732,301              | (1,424,484)      |
| Other-than-temporary impairments on available-for-sale securities  | 1,426,390            | 2,133,252        |
| Derivative instruments and hedging activities gain (loss)  | (3,230,098)          | 64,737,546       |
| Net (gain) loss on sale of loans and impairments   | (599,730)            | 677,005          |
| Net gain on partial extinguishment and recharacterization of secured commercial loans to a local financial institution | (2,497,166)          |                  |
| Net amortization of premiums and discounts and deferred net loan fees and costs  | (240,025)            | (1,014,516)      |
| Amortization of broker placement fees  | 2,165,180            | 3,956,091        |
| Accretion of basis adjustments on fair value hedges  | (115,035)            |                  |
| Net accretion of discounts and premiums on investment securities   | (9,662,676)          | (9,528,614)      |
| Gain on sale of credit card portfolio  | (2,818,972)          |                  |
| Increase in accrued income tax payable   | 7,725,088            | 14,299,995       |
| Decrease (increase) in accrued interest receivable   | 9,310,770            | (46,239)         |
| (Decrease) increase in accrued interest payable  | (30,684,527)         | 4,500,098        |
| Decrease (increase) in other assets  | 4,066,456            | (5,088,301)      |
| Decrease in other liabilities  | (3,370,913)          | (3,331,116)      |
| Total adjustments  | 2,858,876            | 70,538,093       |
| Net cash provided by operating activities  | 25,690,861           | 74,401,335       |
| <b>Cash flows from investing activities:</b>   |                      |                  |
| Principal collected on loans   | 857,281,296          | 892,646,456      |
| Loans originated   | (924,916,547)        | (1,336,279,411)  |
| Purchase of loans  | (49,835,659)         | (58,803,859)     |
| Proceeds from sale of loans  | 46,301,386           | 17,502,647       |
| Proceeds from sale of repossessed assets   | 13,872,963           | 10,136,316       |
| Purchase of servicing assets   | (377,974)            | (147,754)        |
| Proceeds from sale of available for sale securities  | 3,125,310            | 12,670,690       |
| Purchase of securities held to maturity  | (39,387,733)         | (144,226,030)    |

Edgar Filing: FIRST BANCORP /PR/ - Form 10-Q

|   |                |                  |
|---|----------------|------------------|
| Purchase of securities available for sale   |                | (11,975,700)     |
| Principal repayments and maturities of securities held to maturity                      | 210,072,213    | 203,391,488      |
| Principal repayments of securities available for sale                                   | 49,412,753     | 55,367,989       |
| Additions to premises and equipment   | (5,450,790)    | (6,947,568)      |
| (Increase) decrease in other equity securities  | (1,433,200)    | 12,096,100       |
| Net cash provided by (used in) investing activities                                     | 158,664,018    | (354,568,636)    |
| <b>Cash flows from financing activities:</b>  |                |                  |
| Net increase in deposits  | 366,630,490    | 885,705,546      |
| Net decrease in federal funds purchased and securities sold under repurchase agreements | (524,420,500)  | (32,216,500)     |
| Net FHLB advances taken (paid)  | 30,000,000     | (278,000,000)    |
| Dividends paid  | (15,896,781)   | (15,875,780)     |
| Exercise of stock options   |                | 19,756,484       |
| Net cash (used in) provided by financing activities                                     | (143,686,791)  | 579,369,750      |
| Net increase in cash and cash equivalents   | 40,668,088     | 299,202,449      |
| Cash and cash equivalents at beginning of period  | 568,811,024    | 1,380,640,086    |
| Cash and cash equivalents at end of period  | \$ 609,479,112 | \$ 1,679,842,535 |
| Cash and cash equivalents include:  |                |                  |
| Cash and due from banks   | \$ 132,665,435 | \$ 134,396,167   |
| Money market instruments  | 476,813,677    | 1,545,446,368    |
|   | \$ 609,479,112 | \$ 1,679,842,535 |
| <b>Supplemental disclosures of cash flow information:</b>                               |                |                  |
| Cash paid during the period for:  |                |                  |
| Interest on borrowings  | \$ 210,318,801 | \$ 181,142,699   |
| Income taxes  | 479,616        | 5,624,000        |
| Non-cash investing and financing activities:  |                |                  |
| Additions to other real estate owned  | \$ 995,508     | \$ 1,107,755     |
| Additions to auto repossessions   | 29,811,648     | 24,954,864       |
| Capitalization of servicing assets  | 301,850        | 36,491           |
| Recharacterization of secured commercial loans as securities collateralized by loans    | 183,829,925    |                  |
| The accompanying notes are an integral part of these statements.                        |                |                  |

Table of Contents

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

|  | <b>Quarter Ended</b> |                       |
|--|----------------------|-----------------------|
|  | <b>March 31,</b>     |                       |
|  | <b>2007</b>          | <b>March 31, 2006</b> |
| <b>Preferred Stock</b>   | \$ 550,100,000       | \$ 550,100,000        |
| <br>   |                      |                       |
| <b>Common Stock Outstanding:</b>                                       |                      |                       |
| Balance at beginning of period   | 83,254,056           | 80,875,056            |
| Common stock issued under stock option plan                            |                      | 2,379,000             |
| Balance at end of period   | 83,254,056           | 83,254,056            |
| <br>   |                      |                       |
| <b>Additional Paid-In-Capital:</b>                                     |                      |                       |
| Balance at beginning of period   | 22,756,994           |                       |
| Shares issued under stock option plan                                  |                      | 17,377,484            |
| Stock-based compensation recognized                                    | 2,847,950            | 4,892,360             |
| Balance at end of period   | 25,604,944           | 22,269,844            |
| <br>   |                      |                       |
| <b>Legal Surplus</b>   | 276,847,825          | 265,844,192           |
| <br>   |                      |                       |
| <b>Retained Earnings:</b>  |                      |                       |
| Balance at beginning of period   | 326,761,462          | 316,696,971           |
| Net income   | 22,831,985           | 3,863,242             |
| Cash dividends declared on common stock                                | (5,827,782)          | (5,806,781)           |
| Cash dividends declared on preferred stock                             | (10,068,999)         | (10,068,999)          |
| Cumulative adjustment for accounting change (adoption of FIN 48)       | (2,614,795)          |                       |
| Cumulative adjustment for accounting change (adoption of SFAS No. 159) | 91,778,171           |                       |
| Balance at end of period   | 422,860,042          | 304,684,433           |
| <br>   |                      |                       |
| <b>Accumulated Other Comprehensive Loss, net of tax</b>                |                      |                       |
| Balance at beginning of period   | (30,167,151)         | (15,675,284)          |
| Other comprehensive income (loss), net of tax                          | 265,906              | (30,816,013)          |
| Balance at end of period   | (29,901,245)         | (46,491,297)          |
| <br>   |                      |                       |
| Total stockholders equity  | \$ 1,328,765,622     | \$ 1,179,661,228      |

The accompanying notes are an integral part of these statements.

Table of Contents

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

|  | <b>Quarter Ended</b>      |                           |
|--|---------------------------|---------------------------|
|  | <b>March 31,<br/>2007</b> | <b>March 31,<br/>2006</b> |
| Net income   | \$ 22,831,985             | \$ 3,863,242              |
| Other comprehensive income (loss):   |                           |                           |
| Unrealized gain (loss) on securities:  |                           |                           |
| Unrealized holding loss arising during the period  | (1,867,973)               | (31,795,285)              |
| Less: Reclassification adjustments for net loss and other than temporary<br>impairments included in net income | 2,158,691                 | 708,768                   |
| Income tax (expense) benefit related to items of other comprehensive income                                    | (24,812)                  | 270,504                   |
| Other comprehensive income (loss) for the period, net of tax   | 265,906                   | (30,816,013)              |
| Total comprehensive income (loss)  | \$ 23,097,891             | \$ (26,952,771)           |

The accompanying notes are an integral part of these statements.

**Table of Contents**

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

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

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

The results of operations for the quarter ended on March 31, 2007, are not necessarily indicative of the results to be expected for the entire year.

**Recently issued accounting pronouncements**

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

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

With the Corporation's elimination of the use of the long-haul method in connection with the adoption of SFAS 159, the Corporation will no longer amortize or accrete the basis adjustment for the SFAS 159



**Table of Contents**

liabilities. The basis adjustment amortization or accretion is the reversal of the change in value of the hedged brokered CDs and medium-term notes recognized since the implementation of the long-haul method. Since the time the Corporation implemented the long-haul method, it has recognized the basis adjustment and the changes in the value of the hedged brokered CDs and medium-term notes based on the expected call date of the instruments. The adoption of SFAS 159 also requires the recognition, as part of the initial adoption adjustment to retained earnings, of all of the unamortized placement fees that were paid to broker counterparties upon the issuance of the elected brokered CDs and medium-term notes. The Corporation previously amortized those fees through earnings based on the expected call date of the instruments. SFAS 159 also establish that the accrued interest should be reported as part of the fair value of the financial instruments elected to be measured at fair value. The impact of the derecognition of the basis adjustment and the unamortized placement fees as of January 1, 2007 results in a cumulative after-tax reduction to retained earnings of approximately \$23.9 million. This negative charge was included in the total cumulative after-tax increase to retained earnings of \$91.8 million that resulted with the adoption of SFAS 157 and SFAS 159.

In September 2006, the FASB issued SFAS 157, *Fair Value 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 Note 14 to these interim unaudited consolidated financial statements.

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

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

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

**Table of Contents****2 EARNINGS PER COMMON SHARE**

The calculations of earnings (loss) per common share for the quarters ended on March 31, 2007 and 2006 are as follows:

|  | <b>Quarter Ended<br/>March 31,</b>           |             |
|--|--|-------------|
|  | <b>2007</b>                                  | <b>2006</b> |
|  | <b>(In thousands, except per share data)</b> |             |
| <b>Net Income:</b>   |  |             |
| Net income   | \$ 22,832                                    | \$ 3,863    |
| Less: Preferred stock dividend                               | (10,069)                                     | (10,069)    |
| Net income (loss) available to common stockholders           | \$ 12,763                                    | \$ (6,206)  |
| <b>Weighted-Average Shares:</b>                              |  |             |
| Basic weighted-average common shares outstanding             | 83,254                                       | 81,556      |
| Average potential common shares                              | 385  |             |
| Diluted weighted-average number of common shares outstanding | 83,639                                       | 81,556      |
| <b>Earnings (Loss) per common share:</b>                     |  |             |
| Basic  | \$ 0.15                                      | \$ (0.08)   |
| Diluted  | \$ 0.15                                      | \$ (0.08)   |

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 ended on March 31, 2007, a total of 2,054,600 stock options were not included in the computation of outstanding shares because they were antidilutive. As of March 31, 2006, there were 3,043,410 outstanding stock options that were excluded from the computation of diluted earnings per common share because the Corporation reported a net loss available to common stockholders for such period.

**3 STOCK OPTION PLAN**

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



**Table of Contents**

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

On January 1, 2006, the Corporation adopted SFAS 123R, Share-Based Payment using the modified prospective method. Using this method, and since all previously issued stock options were fully vested at the time of the adoption, the Corporation expenses the fair value of all employee stock options granted after January 1, 2006 (same as the prospective method). The compensation expense associated with stock options for the quarters ended March 31, 2007 and 2006 was approximately \$2.8 million and \$4.9 million, respectively. All employee stock options granted during 2007 and 2006 were fully vested at the time of grant.

The activity of stock options during the first quarter of 2007 is set forth below:

|   |                                  | <b>Quarter Ended<br/>March 31, 2007</b>        |  |   |
|---|----------------------------------|--|--|---|
|   | <b>Number<br/>of<br/>options</b> | <b>Weighted-Average<br/>Exercise<br/>Price</b> | <b>Weighted-Average<br/>Remaining<br/>Contractual<br/>Term (Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(In<br/>thousands)</b> |
| Beginning of period                       | 3,024,410                        | \$ 13.95                                       |  |   |
| Options granted                           | 1,170,000                        | 9.20   |  |   |
| End of period outstanding and exercisable | 4,194,410                        | \$ 12.63                                       | 7.6  | \$ 9,967  |

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

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

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

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

**Table of Contents****4 INVESTMENT SECURITIES****Investment Securities Available for Sale**

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

|   | March 31, 2007    |                              |                      |               |                                | December 31, 2006 |                              |                      |               |                                |
|---|-------------------|------------------------------|----------------------|---------------|--------------------------------|-------------------|------------------------------|----------------------|---------------|--------------------------------|
|   | Amortized<br>cost | Gross<br>Unrealized<br>gains | Unrealized<br>losses | Fair<br>value | Weighted<br>average<br>yield % | Amortized<br>cost | Gross<br>Unrealized<br>gains | Unrealized<br>losses | Fair<br>value | Weighted<br>average<br>yield % |
| (Dollars in thousands)  |                   |                              |                      |               |                                |                   |                              |                      |               |                                |
| Obligations of<br>U.S. Government<br>sponsored<br>agencies:   |                   |                              |                      |               |                                |                   |                              |                      |               |                                |
| After 5 to<br>10 years  | \$ 401,706        | \$ 11                        | \$ 9,602             | \$ 392,115    | 4.30                           | \$ 402,542        | \$ 6                         | \$ 11,820            | \$ 390,728    | 4.31                           |
| After 10 years  | 12,984            |                              | 68                   | 12,916        | 6.16                           | 12,984            |                              | 120                  | 12,864        | 6.16                           |
| Puerto Rico<br>Government<br>obligations:                     |                   |                              |                      |               |                                |                   |                              |                      |               |                                |
| After 1 to 5 years  | 5,190             | 147                          |                      | 5,337         | 6.23                           | 4,635             | 126                          |                      | 4,761         | 6.18                           |
| After 5 to<br>10 years  | 15,513            | 211                          | 467                  | 15,257        | 4.85                           | 15,534            | 219                          | 508                  | 15,245        | 4.86                           |
| After 10 years  | 4,938             | 72                           | 177                  | 4,833         | 5.86                           | 5,376             | 98                           | 178                  | 5,296         | 5.88                           |
| United States<br>and Puerto Rico<br>Government<br>obligations | 440,331           | 441                          | 10,314               | 430,458       | 4.42                           | 441,071           | 449                          | 12,626               | 428,894       | 4.43                           |
| Mortgage-backed<br>securities:                                |                   |                              |                      |               |                                |                   |                              |                      |               |                                |
| FHLMC<br>certificates:  |                   |                              |                      |               |                                |                   |                              |                      |               |                                |
| Within 1 year   | 60                |                              |                      | 60            | 5.81                           | 82                |                              |                      | 82            | 5.99                           |
| After 1 to 5 years  | 1,348             | 30                           |                      | 1,378         | 6.89                           | 1,666             | 36                           |                      | 1,702         | 6.98                           |
| After 10 years  | 5,688             | 59                           | 116                  | 5,631         | 5.62                           | 5,846             | 55                           | 110                  | 5,791         | 5.61                           |
|   | 7,096             | 89                           | 116                  | 7,069         | 5.86                           | 7,594             | 91                           | 110                  | 7,575         | 5.92                           |
| GNMA<br>certificates:   |                   |                              |                      |               |                                |                   |                              |                      |               |                                |
| After 1 to 5 years  | 774               | 9                            |                      | 783           | 6.46                           | 866               | 10                           |                      | 876           | 6.44                           |
| After 5 to<br>10 years  | 781               | 4                            | 1                    | 784           | 5.50                           | 795               | 3                            | 3                    | 795           | 5.53                           |
| After 10 years  | 367,610           | 481                          | 6,524                | 361,567       | 5.23                           | 379,363           | 470                          | 7,136                | 372,697       | 5.26                           |
|   | 369,165           | 494                          | 6,525                | 363,134       | 5.23                           | 381,024           | 483                          | 7,139                | 374,368       | 5.26                           |

|                    |              |          |           |              |      |              |          |           |              |      |
|--------------------|--------------|----------|-----------|--------------|------|--------------|----------|-----------|--------------|------|
| FNMA               |              |          |           |              |      |              |          |           |              |      |
| certificates:      |              |          |           |              |      |              |          |           |              |      |
| After 1 to 5 years | 71           |          |           | 71           | 7.24 | 90           |          |           | 90           | 7.34 |
| After 5 to         |              |          |           |              |      |              |          |           |              |      |
| 10 years           | 33,088       | 12       | 464       | 32,636       | 4.81 | 18,040       | 10       | 305       | 17,745       | 4.87 |
| After 10 years     | 815,732      | 807      | 9,061     | 807,478      | 5.19 | 864,508      | 673      | 11,476    | 853,705      | 5.18 |
|                    | 848,891      | 819      | 9,525     | 840,185      | 5.18 | 882,638      | 683      | 11,781    | 871,540      | 5.17 |
| Mortgage           |              |          |           |              |      |              |          |           |              |      |
| pass-through       |              |          |           |              |      |              |          |           |              |      |
| certificates:      |              |          |           |              |      |              |          |           |              |      |
| After 10 years     | 180,274      | 3        | 3,491     | 176,786      | 5.93 | 367          | 3        |           | 370          | 7.28 |
| Mortgage-backed    |              |          |           |              |      |              |          |           |              |      |
| securities         |              |          |           |              |      |              |          |           |              |      |
|                    | 1,405,426    | 1,405    | 19,657    | 1,387,174    | 5.29 | 1,271,623    | 1,260    | 19,030    | 1,253,853    | 5.21 |
| Corporate bonds:   |              |          |           |              |      |              |          |           |              |      |
| After 5 to         |              |          |           |              |      |              |          |           |              |      |
| 10 years           | 1,300        |          | 91        | 1,209        | 7.70 | 1,300        |          | 83        | 1,217        | 7.70 |
| After 10 years     | 4,411        |          | 725       | 3,686        | 7.97 | 4,412        |          | 668       | 3,744        | 7.97 |
| Corporate bonds    | 5,711        |          | 816       | 4,895        | 7.91 | 5,712        |          | 751       | 4,961        | 7.91 |
| Equity securities  |              |          |           |              |      |              |          |           |              |      |
| (without           |              |          |           |              |      |              |          |           |              |      |
| contractual        |              |          |           |              |      |              |          |           |              |      |
| maturity)          |              |          |           |              |      |              |          |           |              |      |
|                    | 7,122        |          | 1,157     | 5,965        | 0.03 | 12,406       | 452      | 143       | 12,715       | 3.70 |
| Total investment   |              |          |           |              |      |              |          |           |              |      |
| securities         |              |          |           |              |      |              |          |           |              |      |
| available for sale | \$ 1,858,590 | \$ 1,846 | \$ 31,944 | \$ 1,828,492 | 5.07 | \$ 1,730,812 | \$ 2,161 | \$ 32,550 | \$ 1,700,423 | 5.01 |

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

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

**Table of Contents**

|   | Less than 12 months |                   | As of March 31, 2007<br>12 months or more |                   | Total        |                   |
|---|---------------------|-------------------|---|-------------------|--------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value                                | Unrealized Losses | Fair Value   | Unrealized Losses |
|   |                     |                   | (In thousands)                            |                   |              |                   |
| <b>Debt securities</b>                            |                     |                   |   |                   |              |                   |
| Obligations of U.S. Government sponsored agencies | \$                  | \$                | \$ 399,058                                | \$ 9,670          | \$ 399,058   | \$ 9,670          |
| Puerto Rico Government obligations                | 75                  |                   | 13,516                                    | 644               | 13,591       | 644               |
| <b>Mortgage-backed securities</b>                 |                     |                   |   |                   |              |                   |
| FHLMC   | 105                 |                   | 3,771                                     | 116               | 3,876        | 116               |
| GNMA  |                     |                   | 343,245                                   | 6,525             | 343,245      | 6,525             |
| FNMA  | 92,645              | 503               | 719,351                                   | 9,022             | 811,996      | 9,525             |
| Mortgage pass-through certificates                | 176,424             | 3,491             |   |                   | 176,424      | 3,491             |
| <b>Corporate bonds</b>                            |                     |                   | 4,895                                     | 816               | 4,895        | 816               |
| <b>Equity securities</b>                          | 1,660               | 112               | 1,394                                     | 1,045             | 3,054        | 1,157             |
|   | \$ 270,909          | \$ 4,106          | \$ 1,485,230                              | \$ 27,838         | \$ 1,756,139 | \$ 31,944         |

|   | Less than 12 months |                   | As of December 31, 2006<br>12 months or more |                   | Total        |                   |
|---|---------------------|-------------------|--|-------------------|--------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value                                   | Unrealized Losses | Fair Value   | Unrealized Losses |
|   |                     |                   | (In thousands)                               |                   |              |                   |
| <b>Debt securities</b>                            |                     |                   |  |                   |              |                   |
| Obligations of U.S. Government sponsored agencies | \$ 21,802           | \$ 146            | \$ 381,790                                   | \$ 11,794         | \$ 403,592   | \$ 11,940         |
| Puerto Rico Government obligations                |                     |                   | 13,474                                       | 686               | 13,474       | 686               |
| <b>Mortgage-backed securities</b>                 |                     |                   |  |                   |              |                   |
| FHLMC   | 30                  |                   | 3,903  | 110               | 3,933        | 110               |
| GNMA  | 354,073             | 7,139             |  |                   | 354,073      | 7,139             |
| FNMA  | 376,813             | 4,719             | 465,606                                      | 7,062             | 842,419      | 11,781            |
| <b>Corporate bonds</b>                            |                     |                   | 4,961  | 751               | 4,961        | 751               |
| <b>Equity securities</b>                          | 1,629               | 143               |  |                   | 1,629        | 143               |
|   | \$ 754,347          | \$ 12,147         | \$ 869,734                                   | \$ 20,403         | \$ 1,624,081 | \$ 32,550         |

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 March 31, 2007, management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments; as a result, the impairments are considered temporary.

During the first quarter of 2007 and 2006, the Corporation recorded other-than-temporary impairments of approximately \$1.4 million and \$2.1 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 and reflected in earnings as a realized loss.



**Table of Contents**

Total proceeds from the sale of securities available for sale during the quarter ended March 31, 2007 amounted to approximately \$3.1 million (2006 \$12.7 million). The Corporation realized gross gains of approximately \$0.2 million and gross losses of approximately \$0.9 million for the first quarter of 2007 (2006 approximately \$1.6 million in gross realized gains and \$0.2 million in gross realized losses).

**Investment Securities Held to Maturity**

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

|  | March 31, 2007    |                              |        |               | December 31, 2006             |                   |                              |        |               |                               |
|--|-------------------|------------------------------|--------|---------------|-------------------------------|-------------------|------------------------------|--------|---------------|-------------------------------|
|  | Amortized<br>cost | Gross<br>Unrealized<br>gains | losses | Fair<br>value | Weighted<br>average<br>yield% | Amortized<br>cost | Gross<br>Unrealized<br>gains | losses | Fair<br>value | Weighted<br>average<br>yield% |
| (Dollars in thousands)                                   |                   |                              |        |               |                               |                   |                              |        |               |                               |
| U.S. Treasury securities:                                |                   |                              |        |               |                               |                   |                              |        |               |                               |
| Due within 1 year  | \$ 59,697         | \$ 9                         | \$     | \$ 59,706     | 5.07                          | \$ 158,402        | \$ 44                        | \$     | \$ 158,446    | 4.97                          |
| Obligations of other U.S. Government sponsored agencies: |                   |                              |        |               |                               |                   |                              |        |               |                               |
| Due within 1 year  |                   |                              |        |               |                               | 24,695            | 5                            |        | 24,700        | 5.25                          |
| After 10 years   | 2,083,587         |                              | 39,700 | 2,043,887     | 5.83                          | 2,074,943         |                              | 53,668 | 2,021,275     | 5.83                          |
| Puerto Rico Government obligations:                      |                   |                              |        |               |                               |                   |                              |        |               |                               |
| After 5 to 10 years                                      | 16,859            | 552                          | 113    | 17,298        | 5.84                          | 16,716            | 553                          | 115    | 17,154        | 5.84                          |
| After 10 years   | 15,000            | 58                           |        | 15,058        | 5.50                          | 15,000            | 53                           |        | 15,053        | 5.50                          |
| United States and Puerto Rico Government obligations     | 2,175,143         | 619                          | 39,813 | 2,135,949     | 5.81                          | 2,289,756         | 655                          | 53,783 | 2,236,628     | 5.76                          |
| Mortgage-backed securities:                              |                   |                              |        |               |                               |                   |                              |        |               |                               |
| FHLMC certificates:                                      |                   |                              |        |               |                               |                   |                              |        |               |                               |
| After 5 to 10 years                                      | 13,934            |                              | 437    | 13,497        | 3.44                          | 15,438            |                              | 577    | 14,861        | 3.61                          |
| FNMA certificates:                                       |                   |                              |        |               |                               |                   |                              |        |               |                               |

Edgar Filing: FIRST BANCORP /PR/ - Form 10-Q

|  |              |        |           |              |      |              |        |           |              |      |
|--|--------------|--------|-----------|--------------|------|--------------|--------|-----------|--------------|------|
| After 5 to<br>10 years                             | 13,301       |        | 392       | 12,909       | 3.80 | 14,234       |        | 484       | 13,750       | 3.80 |
| After 10 years                                     | 981,632      | 18     | 30,840    | 950,810      | 4.40 | 1,025,703    | 48     | 36,064    | 989,687      | 4.40 |
| Mortgage-backed<br>securities                      | 1,008,867    | 18     | 31,669    | 977,216      | 4.38 | 1,055,375    | 48     | 37,125    | 1,018,298    | 4.38 |
| Corporate bonds:<br>After 10 years                 | 2,000        |        | 3         | 1,997        | 5.80 | 2,000        | 40     |           | 2,040        | 5.80 |
| Total investment<br>securities held to<br>maturity | \$ 3,186,010 | \$ 637 | \$ 71,485 | \$ 3,115,162 | 5.35 | \$ 3,347,131 | \$ 743 | \$ 90,908 | \$ 3,256,966 | 5.33 |

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 March 31, 2007 and December 31, 2006.

**Table of Contents**

|  | Less than 12 months |                   | As of March 31, 2007<br>12 months or more |                   | Total        |                   |
|--|---------------------|-------------------|---|-------------------|--------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value (In thousands)                 | Unrealized Losses | Fair Value   | Unrealized Losses |
| <b>Debt securities</b>                   |                     |                   |   |                   |              |                   |
| Other U.S. Government sponsored agencies | \$                  | \$                | \$ 2,043,887                              | \$ 39,700         | \$ 2,043,887 | \$ 39,700         |
| Puerto Rico Government obligations       | 4,032               | 113               |   |                   | 4,032        | 113               |
| <b>Mortgage-backed securities</b>        |                     |                   |   |                   |              |                   |
| FHLMC                                    |                     |                   | 13,497                                    | 437               | 13,497       | 437               |
| FNMA                                     | 24,463              | 960               | 935,958                                   | 30,272            | 960,421      | 31,232            |
| <b>Other investments</b>                 | 1,997               | 3                 |   |                   | 1,997        | 3                 |
|  | \$ 30,492           | \$ 1,076          | \$ 2,993,342                              | \$ 70,409         | \$ 3,023,834 | \$ 71,485         |

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

Held-to-maturity securities in an unrealized loss position at March 31, 2007 are primarily mortgage-backed securities and U.S. agency securities. The vast majority of them are rated the equivalent of AAA by the major rating agencies. The unrealized losses in the held-to-maturity portfolio at March 31, 2007 are substantially related to market interest rate fluctuations and not deterioration in the creditworthiness of the issuers; as a result, the impairment is considered temporary.

**5 OTHER EQUITY SECURITIES**

Institutions that are members of the FHLB system are required to maintain a minimum investment in FHLB stock. Such minimum is calculated as a percentage of aggregate outstanding mortgages and an additional investment

is required that is calculated as a percentage of total FHLB advances, letters of credit, and the collateralized portion of interest-rate swaps outstanding. The stock is capital stock issued at \$100 par value. Both stock and cash dividends may be received on FHLB stock.

As of March 31, 2007 and December 31, 2006, the Corporation had investments in FHLB stock with a book value of \$39.9 million and \$38.4 million, respectively. The estimated market value of such investments is its redemption value determined by the ultimate recoverability of its par value.

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

**Table of Contents****6 LOAN PORTFOLIO**

The following is a detail of the loan portfolio:

|   | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|---------------------------|------------------------------|
|   | <b>(In thousands)</b>     |                              |
| Residential real estate loans, mainly secured by first mortgages  | \$ 2,826,626              | \$ 2,737,392                 |
| Commercial loans:   |                           |                              |
| Construction loans  | 1,454,715                 | 1,511,608                    |
| Commercial mortgage loans   | 1,286,425                 | 1,215,040                    |
| Commercial loans  | 2,730,122                 | 2,698,141                    |
| Loans to local financial institutions collateralized by real estate mortgages and pass-through trust certificates | 679,720                   | 932,013                      |
| Commercial loans  | 6,150,982                 | 6,356,802                    |
| Finance leases  | 377,900                   | 361,631                      |
| Consumer loans  | 1,742,331                 | 1,772,917                    |
| Loans receivable  | 11,097,839                | 11,228,742                   |
| Allowance for loan and lease losses   | (161,419)                 | (158,296)                    |
| Loans receivable, net   | 10,936,420                | 11,070,446                   |
| Loans held for sale   | 26,587                    | 35,238                       |
| Total loans   | \$ 10,963,007             | \$ 11,105,684                |

The Corporation's primary lending area is Puerto Rico. The Corporation's Puerto Rico banking subsidiary, First Bank Puerto Rico ( First Bank or the Bank ) also lends in the U.S. and British Virgin Islands markets and in the United States (principally in the state of Florida). Of the total gross loan portfolio of \$11.1 billion as of March 31, 2007, approximately 78% have credit risk concentration in Puerto Rico, 14% in the United States and 8% in the Virgin Islands.

In February 2007, the Corporation entered into various agreements with R&G Financial Corporation ( R&G Financial ) relating to prior transactions accounted for as commercial loans secured by mortgage loans and pass-through trust certificates from R&G Financial subsidiaries. First, through a mortgage payment agreement, R&G Financial paid the Corporation approximately \$50 million to reduce the commercial loan that R&G Premier Bank, R&G Financial's Puerto Rico banking subsidiary, had outstanding with the Corporation. In addition, the remaining balance of approximately \$271 million was re-documented as a secured loan from the Corporation to R&G Financial. Second, R&G Financial and the Corporation amended various agreements involving, as of the date of the transaction, approximately \$183.8 million of securities collateralized by loans, that were originally sold through five grantor trusts. The modifications to the original agreements allowed the Corporation to treat these transactions as true sales for accounting and legal purposes and the recharacterization of certain secured commercial loans as securities collateralized by loans. The agreements enabled First BanCorp to fulfill the remaining requirement of the Consent

Order signed with banking regulators relating to the mortgage-related transactions with R&G Financial that First BanCorp accounted for as commercial loans secured by the mortgage loans and pass-through trust certificates.

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

**Table of Contents****7 ALLOWANCE FOR LOAN AND LEASE LOSSES**

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

|                                     | <b>Quarter Ended<br/>March 31,</b> |             |
|-------------------------------------|------------------------------------|-------------|
|                                     | <b>2007</b>                        | <b>2006</b> |
|                                     | <b>(In thousands)</b>              |             |
| Balance at beginning of period      | \$ 158,296                         | \$ 147,999  |
| Provision for loan and lease losses | 24,914                             | 19,376      |
| Charge-offs                         | (23,177)                           | (16,449)    |
| Recoveries                          | 1,386                              | 1,670       |
| Balance at end of period            | \$ 161,419                         | \$ 152,596  |

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

|                              | <b>As of<br/>March 31,<br/>2007</b> | <b>As of<br/>December<br/>31,<br/>2006</b> |
|------------------------------|-------------------------------------|--|
|                              | <b>(In thousands)</b>               |  |
| Impaired loans               | \$62,281                            | \$ 63,022                                  |
| Allowance for impaired loans | 8,615                               | 9,989                                      |

Interest income in the amount of approximately \$0.8 million and \$1.2 million was recognized on impaired loans for the quarters ended March 31, 2007 and 2006, respectively.

**8 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

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

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

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

**Table of Contents**

being hedged. As of March 31, 2007, all derivatives held by the Corporation were considered economic undesignated hedges.

Effective January 1, 2007, the Corporation adopted SFAS 159 for its callable brokered CDs and a portion of its callable fixed medium-term notes that were hedged with interest rate swaps. Prior to the implementation of SFAS 159, the Corporation had been following the long-haul method of accounting under SFAS 133, which was adopted on April 3, 2006, for its portfolio of callable interest rate swaps, callable, brokered CDs and callable notes. Interest rate risk on the callable brokered CDs and medium-term notes elected for fair value option under SFAS 159 continues to be economically hedged with callable interest rate swaps.

In addition, effective January 1, 2007, the Corporation discontinued the use of fair value hedge accounting under SFAS 133 for interest rate swaps that hedge its \$150 million medium-term note ( the \$150 million medium-term note ). The Corporation's decision was based on the determination that the interest rate swaps were not longer effective in offsetting the changes in the fair value of the \$150 million medium-term note. After the discontinuance of hedge accounting, the basis adjustment which represents the basis differential between the market value and the book value of the \$150 million medium-term note recognized at the inception of fair value hedge accounting on April 3, 2006, as well as changes in fair value recognized after the inception until the discontinuance of fair value hedge accounting on January 1, 2007, is being amortized or accreted over the remaining life of the liability as a yield adjustment. The \$150 million medium-term note was redeemed prior to its maturity during the second quarter of 2007.

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

|  | <b>Notional amounts</b> |                     |
|--|-------------------------|---------------------|
|  | <b>As of</b>            | <b>As of</b>        |
|  | <b>March 31,</b>        | <b>December 31,</b> |
|  | <b>2007</b>             | <b>2006</b>         |
|  | <b>(In thousands)</b>   |                     |
| Interest rate swap agreements:         |                         |                     |
| Pay fixed versus receive floating      | \$ 80,676               | \$ 80,720           |
| Receive fixed versus pay floating      | 4,777,161               | 4,802,370           |
| Embedded written options               | 13,515                  | 13,515              |
| Purchased options                      | 13,515                  | 13,515              |
| Written interest rate cap agreements   | 128,090                 | 125,200             |
| Purchased interest rate cap agreements | 315,817                 | 330,607             |
|  | <b>\$ 5,328,774</b>     | <b>\$ 5,365,927</b> |

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



**Table of Contents**

|   | <b>Notional amounts</b> |                  |
|---|-------------------------|------------------|
|   | <b>As of</b>            | <b>As of</b>     |
|   | <b>March 31,</b>        | <b>December</b>  |
|   | <b>2007</b>             | <b>31,</b>       |
|   |                         | <b>2006</b>      |
|   | <b>(In thousands)</b>   |                  |
| Economic undesignated hedges:   |                         |                  |
| Interest rate swaps used to hedge fixed rate certificates of deposit, notes payable and loans | \$ 4,857,837            | \$ 336,473       |
| Embedded options on stock index deposits  | 13,515                  | 13,515           |
| Purchased options used to manage exposure to the stock market on embedded stock index options | 13,515                  | 13,515           |
| Written interest rate cap agreements  | 128,090                 | 125,200          |
| Purchased interest rate cap agreements  | 315,817                 | 330,607          |
| <br>Total derivatives not designated as hedges  | <br>\$ 5,328,774        | <br>\$ 819,310   |
| Designated hedges:  |                         |                  |
| Fair value hedges:  |                         |                  |
| Interest rate swaps used to hedge fixed-rate certificates of deposit                          | \$                      | \$ 4,381,175     |
| Interest rate swaps used to hedge fixed- and step-rate notes payable                          |                         | 165,442          |
| <br>Total fair value hedges   | <br>\$                  | <br>\$ 4,546,617 |
| <br>Total   | <br>\$ 5,328,774        | <br>\$ 5,365,927 |

At March 31, 2007, derivatives not designated or not qualifying for hedge accounting with a positive fair value of \$15.4 million (December 31, 2006 \$16.2 million) and a negative fair value of \$123.3 million (December 31, 2006 \$16.3 million) were recorded as part of Other Assets and Accounts payable and other liabilities, respectively, in the Consolidated Statements of Financial Condition.

At December 31, 2006, derivatives qualifying for fair value hedge accounting with a negative fair value of \$126.7 million were recorded as part of Accounts payable and other liabilities in the Consolidated Statements of Financial Condition.

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

**Table of Contents**

|  | <b>As of<br/>March 31,<br/>2007</b> | <b>As of<br/>December 31,<br/>2006</b> |
|--|-------------------------------------|--|
|  | <b>(Dollars in thousands)</b>       |  |
| Pay fixed/receive floating (generally used to economically hedge variable rate loans):                       |                                     |  |
| Notional amount  | \$ 80,676                           | \$ 80,720                              |
| Weighted average receive rate at period end  | 7.25%                               | 7.38%                                  |
| Weighted average pay rate at period end  | 6.75%                               | 6.37%                                  |
| Floating rates range from 167 to 252 basis points over 3-month LIBOR   |                                     |  |
| Receive fixed/pay floating (generally used to economically hedge fixed-rate brokered CDs and notes payable): |                                     |  |
| Notional amount  | \$4,777,161                         | \$4,802,370                            |
| Weighted average receive rate at period end  | 5.18%                               | 5.16%                                  |
| Weighted average pay rate at period end  | 5.40%                               | 5.42%                                  |
| Floating rates range from 5 basis points under to 20 basis points over 3-month LIBOR                         |                                     |  |

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

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

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

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

**Table of Contents****9 GOODWILL AND OTHER INTANGIBLES**

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

At March 31, 2007, the gross carrying amount and accumulated amortization of core deposit intangibles was \$41.2 million and \$15.8 million, respectively, recognized as part of Other Assets in the Consolidated Statements of Financial Condition (December 31, 2006 \$41.2 million and \$15.0 million, respectively). During the quarters ended March 31, 2007 and 2006, the amortization expense of core deposits amounted to \$0.8 million and \$0.9 million, respectively.

**10 DEPOSITS**

The following table summarizes deposit balances:

|   | <b>As of<br/>March 31,<br/>2007</b> | <b>As of<br/>December 31,<br/>2006</b> |
|---|-------------------------------------|--|
|   | <b>(In thousands)</b>               |  |
| Non-interest bearing checking account deposits  | \$ 711,203                          | \$ 790,985                             |
| Saving accounts   | 978,036                             | 984,332                                |
| Interest-bearing checking accounts  | 439,897                             | 433,278                                |
| Certificates of deposit   | 1,599,381                           | 1,696,213                              |
| Brokered certificates of deposit (includes \$4,334,033 measured at fair value as of March 31, 2007) | 7,550,228                           | 7,099,479                              |
|   | <b>\$ 11,278,745</b>                | <b>\$ 11,004,287</b>                   |

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

The following are the components of interest expense on deposits:

**Table of Contents**

|  | <b>Quarter ended March 31,</b> |             |
|--|--------------------------------|-------------|
|  | <b>2007</b>                    | <b>2006</b> |
|  | <b>(In thousands)</b>          |             |
| Interest expense on deposits   | \$ 122,364                     | \$ 117,252  |
| Amortization of broker placement fees (1)  | 2,144                          | 3,949       |
| Interest expense on deposits excluding net unrealized (gain) loss on derivatives (undesignated hedges) and SFAS 159 brokered CDs | 124,508                        | 121,201     |
| Net unrealized (gain) loss on derivatives (undesignated hedges) and SFAS 159 brokered CDs  | (418)                          | 65,637      |
| Total interest expense on deposits   | \$ 124,090                     | \$ 186,838  |

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

Total interest expense on deposits includes interest exchanged on interest rate swaps that economically hedge brokered CDs that for the quarter ended March 31, 2007 amounted to net interest incurred of \$3.8 million (net interest realized of \$3.5 million for the quarter ended March 31, 2006).

**11 NOTES PAYABLE**

Notes payable consists of:

|   | <b>March<br/>31,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|-------------------------------|----------------------------------|
|   | <b>(In thousands)</b>         |                                  |
| Callable fixed-rate notes, bearing interest at 6.00%, maturing on October 1, 2024   | \$ 151,460                    | \$ 151,554                       |
| Callable step-rate notes, bearing step increasing interest from 5.00% to 7.00% maturing on October 18, 2019, measured at fair value under SFAS 159 as of March 31, 2007 | 14,918                        | 15,616                           |
| Dow Jones Industrial Average (DJIA) linked principal protected notes:   |                               |                                  |
| Series A maturing on February 28, 2012  | 7,840                         | 7,525                            |
| Series B maturing on May 27, 2011   | 8,418                         | 8,133                            |
|   | \$ 182,636                    | \$ 182,828                       |



**Table of Contents****12 OTHER BORROWINGS**

Other borrowings consist of:

|  | <b>March<br/>31,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|--|-------------------------------|----------------------------------|
|  | (In thousands)                |                                  |
| Junior subordinated floating rate debentures due in 2034, interest-bearing at a floating-rate of 2.75% over 3-month LIBOR (8.10% at March 31, 2007 and 8.11% at December 31, 2006) | \$ 102,877                    | \$ 102,853                       |
| Junior subordinated floating rate debentures due in 2034, interest-bearing at a floating-rate of 2.50% over 3-month LIBOR (7.85% at March 31, 2007 and 7.87% at December 31, 2006) | 128,866                       | 128,866                          |
|  | \$ 231,743                    | \$ 231,719                       |

**13 INCOME TAXES**

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

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

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

**Table of Contents**

For the quarter ended March 31, 2007, the Corporation recognized an income tax expense of \$6.1 million compared to an income tax benefit of \$11.6 million for the same period in 2006. The fluctuation in the provision for income taxes for the first quarter of 2007, as compared to the first quarter of 2006, was mainly due to a decrease in deferred income tax benefits resulting principally from unrealized gains on derivative instruments and the adoption of SFAS 159, partially offset by a decrease in the current income tax provision. During the first quarter of 2006, the Corporation reflected changes in the fair value of derivative instruments as non-hedging instruments through operations recording unrealized losses of \$69.7 million for derivatives recorded as part of interest expense. The adoption of SFAS 159 reduced the accounting volatility that previously resulted from the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. With the adoption of SFAS 159, changes in the fair value of derivative instruments recorded as part of interest expense (an unrealized gain of \$19.8 million) were partially offset by an unrealized loss on SFAS 159 liabilities of \$19.3 million. For the first quarter of 2007, the Corporation recognized a deferred income tax benefit of \$2.3 million compared to \$28.6 million for the same period in 2006.

The current provision for income taxes for the first quarter of 2007 amounted to \$8.4 million compared to \$17.1 million for the first quarter of 2006, a decrease of \$8.7 million. The decrease in the current income tax provision for the first quarter of 2007 is mainly attributable to lower taxable income.

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 assets will not be realized and thus, established a valuation allowance amounting to \$6.0 million as of March 31, 2007, compared to a valuation allowance of \$6.1 million as of December 31, 2006. As of March 31, 2007, the deferred tax asset, net of the valuation allowance, amounted to approximately \$110.3 million compared to \$162.1 million at December 31, 2006.

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

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

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

**Table of Contents****14 FAIR VALUE**

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

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

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

**Transition Impact**

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

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

**Fair Value Option****Callable Brokered CDs and Certain Medium-Term Notes**

The Corporation elected to account at fair value certain financial liabilities which were hedged with interest rate swaps which were designated for fair value hedge accounting in accordance with SFAS 133. At March 31, 2007, these liabilities included callable brokered CDs with an aggregate fair value of \$4.3 billion and principal balance of \$4.4 billion recorded in interest-bearing deposits; and certain medium-term notes with a fair value of \$14.9 million and principal balance of \$15.4 million recorded in notes payable. Interest paid on these instruments continues to be



recorded in interest expense and the accrued interest is part of the fair value of the SFAS 159 liabilities. Electing the fair value option allows the Corporation to eliminate the burden of complying with the requirements for hedge accounting under SFAS 133 (e.g., documentation and effectiveness assessment) without introducing earnings volatility. Interest rate risk on the callable brokered CDs and medium-term notes elected for fair value option under SFAS 159 continue to be economically hedged with callable interest rate swaps with the same terms and conditions. The Corporation did not elect the fair value option for other brokered CDs and the other callable medium-term note, the \$150 million medium-term note, because these are not hedged by derivatives that qualified for hedge accounting in accordance with SFAS 133. Effective January 1, 2007, the Corporation discontinued the use of fair value hedge accounting for interest rate swaps that hedge the \$150 million medium-term note since the interest rate swaps were not longer effective in offsetting the changes in the fair value of the \$150 million medium-term note. The Corporation redeemed the \$150 million medium-term note during the second quarter of 2007.

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

**Table of Contents*****Fair Value Measurement***

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

- Level 1** Level 1 assets and liabilities include equity securities that are traded in an active exchange market, as well as certain U.S. Treasury and other U.S. government agency securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include (i) mortgage-backed securities for which the fair value is estimated based on valuations obtained from third-party pricing services for identical or comparable assets, (ii) debt securities with quoted prices that are traded less frequently than exchange-traded instruments and (iii) derivative contracts and financial liabilities (e.g. callable brokered CDs and medium-term notes elected for fair value option under SFAS 159) whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, for which the determination of fair value requires significant management judgment or estimation.

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

***Callable Brokered CDs***

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

***Medium-Term Notes***

The fair value of term notes is determined using a discounted cash flow analysis over the full term of the borrowings. This valuation also uses the Hull-White Interest Rate Tree approach to value the option components of the term notes. The model assumes that the embedded options are exercised economically. The fair value of medium-term notes is computed using the notional amount outstanding. The discount rates used in the valuations are based on US dollar LIBOR and swap rates. At-the-money implied swaption volatility term

**Table of Contents**

structure (volatility by time to maturity) is used to calibrate the model to current market prices and value the cancellation option in the term notes. Effective January 1, 2007, the Corporation updated its methodology to calculate the impact of its own credit standing. The net gain from fair value changes attributable to the Corporation's own credit to the medium-term notes that the Corporation has elected to measure at fair value amounted to \$0.9 million for the quarter ended March 31, 2007. For the medium-term notes the credit risk is measured using the difference in yield curves between Swap rates and Treasury rates at a tenor comparable to the time to maturity of the note and the option.

**Investment securities**

The fair value of investment securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers. If listed prices or quotes are not available, fair values is based upon externally developed models that use unobservable inputs due to the limited market activity of the instrument.

**Derivative instruments**

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

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

|                                   | <b>March 31, 2007</b>                |                |                |                      | <b>Changes in Fair Values for the<br/>Quarter Ended<br/>March 31, 2007, for items<br/>Measured at Fair Value<br/>Pursuant<br/>to Election of the Fair Value<br/>Option</b> |  |   |
|-----------------------------------|--------------------------------------|----------------|----------------|----------------------|--|--|---|
|                                   | <b>Fair Value Measurements Using</b> |                |                |                      | <b>(Losses)<br/>Included<br/>in</b>  | <b>(Losses)<br/>Included<br/>in</b>                      | <b>Total<br/>Changes<br/>In<br/>Fair<br/>Values<br/>(Losses)<br/>Included<br/>in<br/>Current-<br/>Period<br/>Earnings<br/>(1)</b> |
| <i>(In thousands)</i>             | <b>Level 1</b>                       | <b>Level 2</b> | <b>Level 3</b> | <b>at Fair Value</b> | <b>Interest<br/>Expense<br/>on<br/>Deposits</b>  | <b>Interest<br/>Expense<br/>on<br/>Notes<br/>Payable</b> |   |
| Callable brokered CDs             | \$                                   | \$(4,334,033)  | \$             | \$(4,334,033)        | \$ (75,177)  | \$   | \$ (75,177)   |
| Medium-term notes                 |                                      | (14,918)       |                | (14,918)             |  | (315)  | (315)   |
| Securities available for sale (2) | 415,892                              | 1,235,814      | 176,786        | 1,828,492            |  |  |   |
| Derivative instruments (3)        |                                      | (117,510)      | 9,583          | (107,927)            |  |  |   |

(1) Changes in fair value for the three-month

period ended  
March 31, 2007  
include interest  
expense on  
callable  
brokered CDs  
and  
medium-term  
notes of  
\$56.0 million  
and  
\$0.2 million,  
respectively.  
Interest expense  
on callable  
brokered CDs  
and  
medium-term  
notes that have  
been elected to  
be carried at fair  
value under the  
provisions of  
SFAS 159 are  
recorded in  
interest expense  
in the  
Consolidated  
Statements of  
Income based  
on their  
contractual  
coupons.

- (2) Carried at fair value prior to the adoption of SFAS 159.
- (3) Derivatives at March 31, 2007 included derivative assets of \$ 15.4 million and derivative liabilities of \$123.3 million, all of which were carried at fair value prior

to the adoption  
of SFAS 159.

The table below presents a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the quarter ended March 31, 2007.

29

---

**Table of Contents**

| <b>Level 3 Instruments Only</b>             | <b>Total Fair Value Measurements<br/>(Quarter ended March 31, 2007)</b> |   |
|---|---|---|
|   | <b>Derivatives(1)</b>   | <b>Securities Available For<br/>Sale(2)</b> |
| <i>(In thousands)</i>                       |   |   |
| Beginning balance                           | \$ 10,288   | \$ 370                                      |
| Total gains (losses) (realized/unrealized): |   |   |
| Included in earnings                        | (705)   |   |
| Included in other comprehensive income      |   | (3,491)                                     |
| New instruments acquired                    |   | 182,376                                     |
| Principal repayment and amortization        |   | (2,469)                                     |
| Transfers in and/or out of Level 3          |   |   |
| Ending balance                              | \$ 9,583  | \$ 176,786                                  |

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

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

The table below summarizes losses due to changes in fair value, recorded in earnings for Level 3 assets and liabilities for the quarter ended March 31, 2007.

| <b>Level 3 Instruments Only</b>   | <b>Total Losses</b>   |  |
|---|-----------------------|--|
|   | <b>Derivatives(1)</b> | <b>Securities Available<br/>For Sale</b> |
| <i>(In thousands)</i>   |                       |  |
| <b>Classification of losses included in earnings for the quarter ended<br/>March 31, 2007 (2) :</b> |                       |  |
| Interest income on loans  | \$ (295)              | \$                                       |
| Interest income on investment securities  | (410)                 |  |

\$ (705)            \$

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

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

The table below summarizes changes in unrealized losses recorded in earnings for the quarter ended March 31, 2007 for Level 3 assets and liabilities that are still held at March 31, 2007.

| <b>Level 3 Instruments Only</b>   | <b>Changes in Unrealized Losses</b> |                                      |
|---|-------------------------------------|--------------------------------------|
| <i>(In thousands)</i>   | <b>Derivatives(1)</b>               | <b>Securities Available For Sale</b> |
| <b>Changes in unrealized losses relating to assets still held at reporting date for the quarter ended March 31, 2007:</b> |                                     |                                      |
| Interest income on loans  | \$ (295)                            | \$                                   |
| Interest income on investment securities  | (410)                               |                                      |
|   | \$ (705)                            | \$                                   |

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

Additionally, fair value is used on a non-recurring basis to evaluate certain assets in accordance with GAAP. Adjustments to fair value usually result from the application of lower-of-cost-or-market accounting (e.g., loans held for sale carried at the lower of cost or fair value and repossessed assets) or write-downs of individual assets (e.g., goodwill). No valuation or impairment adjustment was recognized during the first quarter of 2007 for assets recognized at fair value on a non-recurring basis.





**Table of Contents****15 SEGMENT INFORMATION**

Based upon the Corporation's organizational structure and the information provided to the Chief Operating Decision Maker and to a lesser extent to the Board of Directors, the operating segments are driven primarily by the Corporation's legal entities. At March 31, 2007, the Corporation had four reportable segments: Commercial and Corporate Banking; Mortgage Banking; Consumer (Retail) Banking; and Treasury and Investments, as well as an Other category reflecting other legal entities reported separately on an aggregate basis. Management determined the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. Other factors such as the Corporation's organizational chart, nature of the products, distribution channels and the economic characteristics of the products were also considered in the determination of the reportable segments.

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

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

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

**Table of Contents**

|  | <b>Mortgage<br/>Banking</b> | <b>Consumer</b> | <b>Commercial<br/>and<br/>Corporate</b> | <b>Treasury<br/>and<br/>Investments</b> | <b>Other</b> | <b>Total</b>  |
|--|-----------------------------|-----------------|---|---|--------------|---------------|
| <b>For the quarter<br/>ended March 31,<br/>2007:</b>   |                             |                 |   |   |              |               |
| Interest income  | \$ 39,874                   | \$ 47,132       | \$ 107,895                              | \$ 72,204                               | \$ 31,480    | \$ 298,585    |
| Net (charge) credit for<br>transfer of funds   | (29,822)                    | 27,959          | (72,669)                                | 80,477                                  | (5,945)      |               |
| Interest expense   |                             | (19,163)        |   | (154,506)                               | (7,481)      | (181,150)     |
| Net interest income  | 10,052                      | 55,928          | 35,226                                  | (1,825)                                 | 18,054       | 117,435       |
| Recovery<br>(provision) for loan<br>and lease losses   | 51                          | (15,596)        | (5,907)                                 |   | (3,462)      | (24,914)      |
| Other income (loss)  | 782                         | 8,868           | 744                                     | (2,019)                                 | 4,950        | 13,325        |
| Net gain on partial<br>extinguishment and<br>recharacterization of<br>secured commercial<br>loan to a local<br>financial institution |                             |                 | 2,497                                   |   |              | 2,497         |
| Direct operating<br>expenses   | (5,247)                     | (22,745)        | (5,850)                                 | (2,078)                                 | (11,506)     | (47,426)      |
| Segment income   | \$ 5,638                    | \$ 26,455       | \$ 26,710                               | \$ (5,922)                              | \$ 8,036     | \$ 60,917     |
| Average earnings<br>assets   | \$ 2,459,305                | \$ 1,868,497    | \$ 5,490,294                            | \$ 5,507,106                            | \$ 1,267,459 | \$ 16,592,661 |
| <b>For the quarter<br/>ended March 31,<br/>2006:</b>   |                             |                 |   |   |              |               |
| Interest income  | \$ 35,324                   | \$ 49,973       | \$ 134,448                              | \$ 80,956                               | \$ 27,004    | \$ 327,705    |
| Net (charge) credit for<br>transfer of funds   | (23,537)                    | 25,071          | (89,131)                                | 92,026                                  | (4,429)      |               |
| Interest expense   |                             | (16,031)        |   | (233,517)                               | (5,338)      | (254,886)     |
| Net interest income<br>(loss)  | 11,787                      | 59,013          | 45,317                                  | (60,535)                                | 17,237       | 72,819        |
| Provision for loan and<br>lease losses   | (326)                       | (13,285)        | (832)                                   |   | (4,933)      | (19,376)      |
| Other (loss) income  | (554)                       | 5,836           | 918                                     | (910)                                   | 5,298        | 10,588        |
|  | (3,585)                     | (21,413)        | (5,239)                                 | (1,856)                                 | (10,481)     | (42,574)      |

Direct operating expenses

|                |          |           |           |             |          |           |
|----------------|----------|-----------|-----------|-------------|----------|-----------|
| Segment income | \$ 7,322 | \$ 30,151 | \$ 40,164 | \$ (63,301) | \$ 7,121 | \$ 21,457 |
|----------------|----------|-----------|-----------|-------------|----------|-----------|

Average earnings assets

|  |              |              |              |              |              |               |
|--|--------------|--------------|--------------|--------------|--------------|---------------|
|  | \$ 2,136,483 | \$ 1,936,044 | \$ 7,662,139 | \$ 6,391,152 | \$ 1,078,831 | \$ 19,204,649 |
|--|--------------|--------------|--------------|--------------|--------------|---------------|

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

|   | <b>Quarter Ended<br/>March 31,</b> |               |
|---|------------------------------------|---------------|
|   | <b>2007</b>                        | <b>2006</b>   |
| <b>Net income:</b>                        |                                    |               |
| Total income for segments and other       | \$ 60,917                          | \$ 21,457     |
| Other operating expenses                  | (31,938)                           | (29,164)      |
| Income (loss) before income taxes         | 28,979                             | (7,707)       |
| Income tax (expense) benefit              | (6,147)                            | 11,570        |
| Total consolidated net income             | \$ 22,832                          | \$ 3,863      |
| <b>Average assets:</b>                    |                                    |               |
| Total average earning assets for segments | \$ 16,592,661                      | \$ 19,204,649 |
| Average non-earning assets                | 516,559                            | 673,872       |
| Total consolidated average assets         | \$ 17,109,220                      | \$ 19,878,521 |

## 16 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 March 31, 2007, commitments to extend credit amounted to approximately \$1.9 billion and standby letters of credit amounted to approximately \$100.0 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.

**Table of Contents**

As of March 31, 2007, 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.

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's accounting for the mortgage-related transactions with Doral Financial Corporation (Doral) and R&G Financial. The Corporation had announced on December 13, 2005 that management, with the concurrence of the Board of Directors, had determined to restate its previously reported financial statements to correct its accounting for the mortgage-related transactions. 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.

Under the settlement with the SEC, the Corporation agreed, without admitting or denying any wrongdoing, to be enjoined from future violations of certain provisions of the securities laws. The Corporation also agreed to 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.

In 2007, the Corporation reached an agreement in principle and signed a memorandum of understanding with the lead plaintiff in a consolidated securities class action relating to accounting for the mortgage-related transactions named *In Re: First BanCorp Securities Litigations*. 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 District Court issued a Preliminary Order approving the stipulation of this settlement. 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; which was paid on August 16, 2007 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 November 28, 2007. The remaining settlement payment in the 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 the potential settlement of the class action lawsuit.

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, has not made accruals for any potential payment from its insurance carriers.

**Table of Contents****17 FIRST BANCORP (Holding Company Only) Financial Information**

The following condensed financial information presents the financial position of the Holding Company only at March 31, 2007 and December 31, 2006 and the results of its operations for the quarters ended on March 31, 2007 and 2006.

|  | <b>As of<br/>March 31,<br/>2007</b> | <b>As of<br/>December<br/>31,<br/>2006</b> |
|--|-------------------------------------|--|
|  | (In thousands)                      |  |
| <b>Assets</b>  |                                     |  |
| Cash and due from banks                              | \$ 46,302                           | \$ 14,584                                  |
| Money market investments                             | 300                                 | 300  |
| Investment securities available for sale, at market: |                                     |  |
| Mortgage-backed securities                           | 55,966                              |  |
| Equity investments                                   | 5,965                               | 12,715                                     |
| Other equity securities                              | 1,425                               | 1,425                                      |
| Loans receivable, net                                | 2,634                               | 65,161                                     |
| Investment in FirstBank Puerto Rico                  | 1,431,694                           | 1,309,066                                  |
| Investment in FirstBank Insurance Agency             | 2,798                               | 2,982                                      |
| Investment in Ponce General Corporation              | 103,646                             | 103,274                                    |
| Investment in PR Finance                             | 2,716                               | 2,623                                      |
| Accrued interest receivable                          | 381                                 | 401  |
| Investment in FBP Statutory Trust I                  | 3,093                               | 3,093                                      |
| Investment in FBP Statutory Trust II                 | 3,866                               | 3,866                                      |
| Other assets   | 44,043                              | 84,664                                     |
| <b>Total assets</b>                                  | <b>\$ 1,704,829</b>                 | <b>\$ 1,604,154</b>                        |
| <b>Liabilities &amp; Stockholders Equity</b>         |                                     |  |
| <b>Liabilities:</b>                                  |                                     |  |
| Other borrowings                                     | \$ 286,843                          | \$ 288,269                                 |
| Accounts payable and other liabilities               | 89,220                              | 86,332                                     |
| <b>Total liabilities</b>                             | <b>376,063</b>                      | <b>374,601</b>                             |
| <b>Stockholders equity</b>                           | <b>1,328,766</b>                    | <b>1,229,553</b>                           |
| <b>Total liabilities and stockholders equity</b>     | <b>\$ 1,704,829</b>                 | <b>\$ 1,604,154</b>                        |

**Table of Contents**

|  | <b>Quarter<br/>Ended<br/>March<br/>31,<br/>2007</b> | <b>Quarter<br/>Ended<br/>March 31,<br/>2006</b> |
|--|---|---|
|  | <b>(In thousands)</b>                               |   |
| <b>Income:</b>   |   |   |
| Interest income on investment securities   | \$ 583  | \$ 178  |
| Interest income on other investments   | 11  | 3   |
| Interest income on loans   | 373   | 1,053   |
| Dividend from FirstBank Puerto Rico  | 2,028   | 17,127  |
| Dividend from other subsidiaries   | 1,000   | 4,000   |
| Other income   | 139   | 124   |
|  | 4,134   | 22,485  |
| <b>Expense:</b>  |   |   |
| Notes payable and other borrowings   | 4,670   | 4,146   |
| Interest on funding to subsidiaries  | 865   | 742   |
| Provision (recovery) for loan losses   | 1,320   | (71)  |
| Other operating expenses   | 994   | 1,256   |
|  | 7,849   | 6,073   |
| Loss on sale of investments and impairments, net   | (2,159)   | (1,033)   |
| Net loss on partial extinguishment and recharacterization of secured commercial loans to a local financial institution | (1,207)   |   |
| <b>(Loss) income before income tax provision and equity in undistributed earnings (loss) of subsidiaries</b>           | <b>(7,081)</b>                                      | <b>15,379</b>                                   |
| Income tax benefit   | 1,289   | 1,088   |
| <b>Equity in undistributed earnings (loss) of subsidiaries</b>   | <b>28,624</b>                                       | <b>(12,604)</b>                                 |
| <b>Net income</b>  | <b>\$ 22,832</b>                                    | <b>\$ 3,863</b>                                 |

**Table of Contents**

**18 SUBSEQUENT EVENTS**

On August 27, 2007, the Corporation announced the completion of its sale of 9.250 million shares of First BanCorp's common stock to the Bank of Nova Scotia ( Scotiabank ) in a private placement. Scotiabank paid a purchase price of \$10.25 per First BanCorp's common share, for a total purchase price of approximately \$94.8 million. Scotiabank acquired 10% of First BanCorp's outstanding common shares as of the close of the transaction. As of August 31, 2007, First BanCorp had 92,504,056 common shares outstanding.

36

---

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (MD&A)****SELECTED FINANCIAL DATA**

(In thousands except for per share and financial ratios)

|   | Quarter ended<br>March 31, |                              |
|---|----------------------------|------------------------------|
|   | 2007                       | 2006                         |
| <b>Condensed income statements:</b>                     |                            |                              |
| Total interest income                                   | \$298,585                  | \$327,705                    |
| Total interest expense                                  | 181,150                    | 254,886                      |
| Net interest income                                     | 117,435                    | 72,819                       |
| Provision for loan and lease losses                     | 24,914                     | 19,376                       |
| Non-interest income                                     | 15,822                     | 10,588                       |
| Non-interest expenses                                   | 79,364                     | 71,738                       |
| Income (loss) before income tax                         | 28,979                     | (7,707)                      |
| Income tax (expense) benefit                            | (6,147)                    | 11,570                       |
| Net income  | 22,832                     | 3,863                        |
| Net income (loss) attributable to common stockholders   | 12,763                     | (6,206)                      |
| <b>Per common share results:</b>                        |                            |                              |
| Net income (loss) per share-basic                       | \$ 0.15                    | \$ (0.08)                    |
| Net income (loss) per share-diluted                     | \$ 0.15                    | \$ (0.08)                    |
| Cash dividends declared                                 | \$ 0.07                    | \$ 0.07                      |
| Average shares outstanding                              | 83,254                     | 81,556                       |
| Average shares outstanding diluted                      | 83,639                     | 81,556                       |
| Book value per common share                             | \$ 9.35                    | \$ 7.56                      |
| <b>Selected financial ratios (in percent):</b>          |                            |                              |
| <b>Profitability:</b>                                   |                            |                              |
| Return on average assets                                | 0.53                       | 0.08                         |
| Interest rate spread (1)                                | 2.38                       | 2.66                         |
| Net interest margin (1)                                 | 2.94                       | 3.11                         |
| Return on average total equity                          | 7.78                       | 1.28                         |
| Return on average common equity                         | 8.19                       | (3.76)                       |
| Average total equity to average total assets            | 6.86                       | 6.09                         |
| Dividend payout ratio                                   | 45.66                      | (93.57)                      |
| Efficiency ratio (2)                                    | 59.56                      | 86.01                        |
| <b>Asset quality:</b>                                   |                            |                              |
| Allowance for loan and lease losses to loans receivable | 1.45                       | 1.17                         |
| Net charge-offs annualized to average loans             | 0.78                       | 0.46                         |
| Provision for loan and lease losses to net charge-offs  | 1.14                       | 1.31                         |
| <b>Other information:</b>                               |                            |                              |
| Common stock price: end of period                       | \$ 13.26                   | \$ 12.36                     |
|   | <b>March 31,<br/>2007</b>  | <b>December 31,<br/>2006</b> |
| <b>Balance sheet data:</b>                              |                            |                              |
| Loans and loans held for sale                           | \$11,124,426               | \$11,263,980                 |
| Allowance for loan and lease losses                     | 161,419                    | 158,296                      |
| Money market and investment securities                  | 5,532,908                  | 5,544,183                    |



|                     |            |            |
|---------------------|------------|------------|
| Total assets        | 17,194,945 | 17,390,256 |
| Deposits            | 11,278,745 | 11,004,287 |
| Borrowings          | 4,167,683  | 4,662,271  |
| Total common equity | 778,666    | 679,453    |
| Total equity        | 1,328,766  | 1,229,553  |

1- On a tax equivalent basis (see discussion in Net Interest Income below).

2- Non-interest expenses 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 and financial instruments measured at fair value under SFAS 159.

**Table of Contents****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 March 31, 2007 as a result of the delay in completing the restatement of the Corporation's audited financial statements for the years ended December 31, 2004, 2003 and 2002, and the unaudited selected quarterly financial information for each of the four quarters of 2004, 2003 and 2002, which resulted in delays in the filing of an amendment of First BanCorp's Annual Report on Form 10-K for the year ended December 31, 2004 and consequent delays in the filing of the Corporation's subsequent reports.

**OVERVIEW OF RESULTS OF OPERATIONS**

This discussion and analysis relates to the accompanying consolidated interim unaudited financial statements of 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 results of its hedging activities, gains (losses) on investments, gains (losses) on sale of loans, and income taxes.

For the quarter ended March 31, 2007, the Corporation's net income was \$22.8 million, compared to net income of \$3.9 million for the quarter ended March 31, 2006. For the quarter ended March 31, 2007, diluted earnings per common share amounted to \$0.15, compared to a loss per common share of \$0.08 for the same period in 2006. Return on average assets and return on average common equity were 0.53% and 8.19% respectively, for the first quarter of 2007 as compared to 0.08% and (3.76)%, respectively, for the same quarter of 2006. The Corporation's financial performance for the first quarter of 2007, as compared to the first quarter of 2006, was principally impacted by: (1) the adoption during the first quarter of 2007 of the fair value option under Statement of Financial Accounting Standards No. (SFAS) 159 The Fair Value Option for Financial Assets and Financial Liabilities, for the Corporation's callable brokered CDs and certain medium-term notes (SFAS 159 liabilities), and (2) higher non-interest income due to a non-recurring gain on the sale of the Corporation's credit card portfolio and a net gain on the partial extinguishment and recharacterization of certain secured commercial loans extended to a local financial institution, which is discussed below, as well as higher income on its mortgage banking activities. These were partially offset by higher provisions for loan and lease losses, higher employees' compensation and benefits expenses as well as higher occupancy and equipment and income tax expenses.

The highlights and key drivers of the Corporation's financial results for the quarter ended March 31, 2007 included the following:

For the quarter ended March 31, 2007, the Corporation's operations resulted in a net income of \$22.8 million, compared to \$3.9 million for the quarter ended March 31, 2006. After payment of preferred stock dividends, the Corporation's net income attributable to common stockholders for the quarter ended March 31, 2007 amounted to \$12.8 million, compared to a net loss attributable to common stockholders of \$6.2 million for the quarter ended March 31, 2006.

**Table of Contents**

Diluted earnings per common share for the quarter ended March 31, 2007 was \$0.15, compared to a loss per common share of \$0.08 for the quarter ended March 31, 2006.

Net interest income for the quarters ended March 31, 2007 and 2006 was \$117.4 million and \$72.8 million, respectively. Net interest income fluctuated significantly due to the adoption of SFAS 159, effective January 1, 2007. For the first quarter of 2007, the change in the valuation of derivatives and unrealized losses on SFAS 159 liabilities recorded as part of interest expense resulted in net unrealized gains of approximately \$0.5 million compared to net unrealized losses of \$69.7 million for the same period in 2006. These positive factors were partially offset by a reduction in the Corporation's average interest-earning assets and by a compression in the net interest spread and margin due to the flattening of the yield curve. Refer to the *Net Interest Income* discussion below for further details.

On a tax equivalent basis, excluding the changes in the fair value of derivative instruments, the basis adjustment amortization or accretion, and the changes in the fair value of SFAS 159 liabilities (for definition and reconciliation of this non-GAAP measure, refer to the *Net Interest Income* discussion below), net interest income for the quarters ended March 31, 2007 and 2006 was \$121.8 million and \$148.4 million, respectively. The decrease in tax-equivalent net interest income, when excluding the changes in the fair value of derivative instruments, the basis adjustment amortization or accretion, and unrealized losses on SFAS 159 liabilities, was mainly due to a reduction in the Corporation's average interest-earning assets of \$2.6 billion, or 13%, coupled with a compression in net interest margin due to the flattening of the yield curve and fluctuations in net interest settlements on interest rate swaps. The net interest margin on a tax equivalent basis was 2.94% for the quarter ended March 31, 2007, compared to 3.11% for the same period in 2006, respectively. The compression 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, other than short-term money market investments (allocating a funding cost equal to the weighted-average cost of the Corporation's other borrowed funds), was approximately 0.38% for the quarter ended March 31, 2007 compared to 1.32% for the quarter ended March 31, 2006. Increases in short-term interest rates resulted in a change in net interest settlements on interest rate swaps included as part of interest expense. For the quarter ended March 31, 2007, the net interest settlement on such interest rate swaps resulted in additional charges to interest expense of \$3.8 million, compared to benefits of \$3.5 million recognized as a reduction to interest expense for the same period in 2006, as the rates paid by the Corporation during 2007 under the variable portion of the swaps exceeded the rates received by the Corporation under the fixed portion of the swaps.

For the first quarter of 2007, the Corporation provided \$24.9 million for loan and lease losses, as compared to \$19.4 million for the same period in 2006. Refer to the discussion under the *Risk Management* section below for an analysis of the allowance for loan and lease losses and non-performing assets and related ratios. The increase in the provision for 2007 was mainly due to increasing trends in non-accruing loans and charge-offs experienced during 2007 compared to the first quarter of 2006. The Corporation's trends in non-accruing loans 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, causing delinquency trends in consumer and commercial loan portfolios to increase.

Non-interest income for the first quarter of 2007 and 2006 was \$15.8 million and \$10.6 million, respectively. The increase in non-interest income for the first quarter of 2007, compared to the first quarter of 2006, was mainly due to a \$2.8 million gain on the sale of the Corporation's credit card portfolio and a \$2.5 million net gain on the partial extinguishment and recharacterization of certain secured commercial loans extended to a local financial institution coupled with higher earnings in the Corporation's mortgage banking activities partially offset by losses on the sale of investments.

**Table of Contents**

The Corporation's non-interest expenses for the first quarter of 2007 were \$79.4 million compared to \$71.7 million for the first quarter of 2006. The increase in non-interest expenses for 2007 was mainly due to increases in employees' compensation and benefits, occupancy and equipment expenses, business promotion expenses and legal contingencies, partially offset by a decrease in legal, accounting and consulting fees expenses due to the conclusion during the third quarter of 2006 of the internal review conducted by the Corporation's Audit Committee and the restatement process.

For the quarter ended March 31, 2007, the Corporation reported an income tax expense of \$6.1 million, compared to an income tax benefit of \$11.6 million for the same period in 2006. The variance in income tax provision for the first quarter of 2007 as compared to the first quarter of 2006 was mainly due to a reduction in deferred tax benefits associated with the adoption of SFAS 159 partially offset by a decrease in the current income tax provision. During the first quarter of 2006, the Corporation reflected changes in the fair value of derivative instruments (an unrealized loss of \$69.7 million for changes in fair value recorded as part of interest expense) as non-hedging instruments through operations. With the adoption of SFAS 159, effective January 1, 2007, changes in the fair value of derivatives recorded as part of interest expense (an unrealized gain of \$19.8 million) were partially offset by unrealized losses on SFAS 159 liabilities of \$19.3 million. The Corporation recognized a deferred tax benefit of \$2.3 million for the first quarter of 2007 compared to \$28.6 million for the same period in 2006.

Total assets at March 31, 2007 amounted to \$17.2 billion, a decrease of \$195.3 million compared to total assets of \$17.4 billion at December 31, 2006. The decrease in total assets at March 31, 2007, compared to total assets at December 31, 2006, was mainly the result of a decrease in the Corporation's investment securities portfolio as well as a decrease in the Corporation's deferred tax asset partially offset by an increase in money market instruments. Notwithstanding the recognition, as of March 31, 2007, of securities collateralized by loans with a fair market value of \$176.4 million, obtained as part of the execution of various agreements entered into with R&G Financial Corporation (R&G Financial), the Corporation's investment portfolio decreased by \$31.6 million as compared to the balance as of December 31, 2006. The decrease in investment securities resulted from maturities and prepayments received from the Corporation's investment portfolio, principally 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.

During the first quarter of 2007, the Corporation entered into various agreements with R&G Financial relating to prior transactions accounted for as commercial loans secured by mortgage loans and pass-through trust certificates from R&G Financial subsidiaries. First, through a mortgage payment agreement, R&G Financial paid the Corporation approximately \$50 million to reduce the commercial loan that R&G Premier Bank, R&G Financial's banking subsidiary, had outstanding with the Corporation. In addition, the remaining balance of \$271 million was re-documented as a secured loan from the Corporation to R&G Financial. Second, R&G Financial and the Corporation amended various agreements involving, as of the date of the transaction, approximately \$183.8 million of securities collateralized by loans that were originally sold through five grantor trusts. The modifications to the original agreements allow the Corporation to treat these transactions as true sales for accounting and legal purposes. The execution of the agreements caused a decrease in the Corporation's loan portfolio and an increase in the Corporation's investment securities portfolio.

As of March 31, 2007, total liabilities amounted to \$15.9 billion, a decrease of \$294.5 million as compared to \$16.2 billion as of December 31, 2006. The decrease in total liabilities as of March 31, 2007, compared to December 31, 2006, was mainly due to a decrease in federal funds purchased and securities sold under repurchased agreements partially offset by an increase in deposits. The decrease in federal funds purchased and securities sold under repurchased agreements was mainly attributable to the Corporation's decision to deleverage its investment portfolio. The increase in deposits was attributable to increases in brokered CDs.



**Table of Contents**

Total loan production for the quarter ended March 31, 2007 was \$974.8 million, a decrease of \$420.3 million, or 30%, compared to the same period in 2006. The decrease in loan production during 2007 was mainly due to decreases in residential real estate, commercial, and consumer loan originations which were negatively impacted by higher prevailing interest rates, worsening economic conditions in Puerto Rico, and stricter underwriting guidelines.

**Critical Accounting Policies and Practices**

The accounting principles of the Corporation and the methods of applying these principles conform with generally accepted accounting principles in the United States and to general practices within the banking industry. The Corporation's critical accounting policies relate to the 1) allowance for loan and lease losses; 2) other-than-temporary impairments; 3) income taxes; 4) classification and related values of investment securities; 5) valuation of financial instruments; 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 2006 Annual Report on Form 10-K.

**Recently Adopted Accounting Pronouncement**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued SFAS 159. This Statement allows entities to choose to measure certain financial assets and liabilities at fair value with changes in fair value reflected in earnings. The fair value option may be applied on an instrument-by-instrument basis. This Statement is effective for periods after November 15, 2007, however, early adoption is permitted provided that the entity also elects to apply the provisions of SFAS 157, Fair Value Measurements . The Corporation adopted SFAS 159 and SFAS 157 effective January 1, 2007. The Corporation decided to early adopt SFAS 159 for the callable brokered certificates of deposit ( CDs ) and a portion of the callable fixed medium-term notes, both of which were hedged with interest rate swaps. First BanCorp had been following the long-haul method of accounting, which was adopted on April 3, 2006, under SFAS 133, Accounting for Derivative Instruments and Hedging Activities , for the portfolio of callable interest rate swaps, callable brokered CDs and callable notes. One of the main considerations in determining to early adopt SFAS 159 for these instruments was to eliminate the operational procedures required by the long-haul method of accounting in terms of documentation, effectiveness assessment, and manual procedures followed by the Corporation to fulfill the requirements specified by SFAS 133.

With the Corporation's elimination of the use of the long-haul method in connection with the adoption of SFAS 159, the Corporation will no longer amortize or accrete the basis adjustment for the SFAS 159 liabilities. The basis adjustment amortization or accretion is the reversal of the change in value of the hedged brokered CDs and medium-term notes recognized since the implementation of the long-haul method. Since the time the Corporation implemented the long-haul method, it has recognized the basis adjustment and the changes in the value of the hedged brokered CDs and medium-term notes based on the expected call date of the instruments. The adoption of SFAS 159 also requires the recognition, as part of the initial adoption adjustment to retained earnings, of all of the unamortized placement fees that were paid to broker counterparties upon the issuance of the elected brokered CDs and medium-term notes. The Corporation previously amortized those fees

**Table of Contents**

through earnings based on the expected call date of the instruments. SFAS 159 also establish that the accrued interest should be reported as part of the fair value of the financial instruments elected to be measured at fair value.

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

For additional information and further details on the adoption of SFAS 157, SFAS 159 and FIN 48 as well as other recently adopted accounting pronouncements, refer to Notes 1, 13 and 14 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 ended March 31, 2007 was \$117.4 million, compared to \$72.8 million for the comparable period in 2006. On a tax equivalent basis, excluding the changes in the fair value of derivative instruments, the basis adjustment amortization or accretion, and unrealized losses on SFAS 159 liabilities, net interest income for the quarters ended March 31, 2007 and 2006 was \$121.8 million and \$148.4 million, respectively.

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

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 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 the quarter ended March 31, 2007, 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 basis adjustment amortization or accretion and (3) unrealized gains or losses on SFAS 159 liabilities. For the quarter ended March 31, 2006, 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).

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

| Quarter ended March 31,                | Average volume         |               | Interest Income (1) /<br>expense |            | Average rate (1) |        |
|--|------------------------|---------------|----------------------------------|------------|------------------|--------|
|  | 2007                   | 2006          | 2007                             | 2006       | 2007             | 2006   |
|  | (Dollars in thousands) |               |                                  |            |                  |        |
| Earning assets:                        |                        |               |                                  |            |                  |        |
| Money market investments               | \$ 407,564             | \$ 959,644    | \$ 5,378                         | \$ 9,975   | 5.35%            | 4.22%  |
| Government obligations (2)             | 2,707,843              | 2,752,308     | 40,009                           | 42,669     | 5.99%            | 6.29%  |
| Mortgage-backed securities             | 2,383,172              | 2,648,290     | 29,973                           | 36,432     | 5.10%            | 5.58%  |
| Corporate bonds                        | 28,788                 | 26,417        | 477                              | 434        | 6.72%            | 6.67%  |
| FHLB stock                             | 41,527                 | 34,984        | 454                              | 782        | 4.44%            | 9.07%  |
| Equity securities                      | 12,240                 | 31,333        | 1                                | 213        | 0.03%            | 2.75%  |
| Total investments (3)                  | 5,581,134              | 6,452,976     | 76,292                           | 90,505     | 5.54%            | 5.69%  |
| Residential real estate loans          | 2,803,244              | 2,427,139     | 45,521                           | 40,301     | 6.59%            | 6.73%  |
| Construction loans                     | 1,484,913              | 1,299,154     | 31,813                           | 26,809     | 8.69%            | 8.37%  |
| Commercial loans                       | 4,770,211              | 7,138,251     | 89,965                           | 116,386    | 7.65%            | 6.61%  |
| Finance leases                         | 369,977                | 292,304       | 8,237                            | 6,712      | 9.03%            | 9.31%  |
| Consumer loans                         | 1,773,461              | 1,765,586     | 51,686                           | 52,849     | 11.82%           | 12.14% |
| Total loans (4) (5)                    | 11,201,806             | 12,922,434    | 227,222                          | 243,057    | 8.23%            | 7.63%  |
| Total earning assets                   | \$ 16,782,940          | \$ 19,375,410 | \$ 303,514                       | \$ 333,562 | 7.33%            | 6.98%  |
| Interest-bearing liabilities:          |                        |               |                                  |            |                  |        |
| Interest-bearing deposits              | \$ 10,420,609          | \$ 11,782,530 | \$ 124,508                       | \$ 121,201 | 4.85%            | 4.18%  |
| Other borrowed funds                   | 3,837,002              | 5,236,363     | 49,021                           | 59,787     | 5.18%            | 4.63%  |
| FHLB advances                          | 616,776                | 373,389       | 8,197                            | 4,178      | 5.39%            | 4.54%  |
| Total interest-bearing liabilities (6) | \$ 14,874,387          | \$ 17,392,282 | \$ 181,726                       | \$ 185,166 | 4.95%            | 4.32%  |
| Net interest income                    |                        |               | \$ 121,788                       | \$ 148,396 |                  |        |
| Interest rate spread                   |                        |               |                                  |            | 2.38%            | 2.66%  |
| Net interest margin                    |                        |               |                                  |            | 2.94%            | 3.11%  |

(1) On a tax equivalent basis. The tax equivalent yield was estimated by dividing the interest rate spread on exempt assets by (1 less



PR statutory tax rate (39% for 2007 and 41.5% for 2006)) 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, unrealized gains or losses on SFAS 159 liabilities, and basis adjustment amortization or accretion are excluded from interest income and interest expense for average rate calculation purposes because these changes do not affect interest paid or received.

- (2) Government obligations include debt issued by government sponsored agencies.
- (3) Unrealized gains and losses in available-for-sale securities are excluded from the average volumes.
- (4)

Average loan balances include the average of non-accruing loans, on which interest income is recognized when collected.

- (5) Interest income on loans includes \$3.5 million and \$3.6 million for the first quarter of 2007 and 2006, respectively, of income from prepayment penalties and late fees related to the Corporation's loan portfolio.
- (6) Unrealized gains and losses on SFAS 159 liabilities are excluded from the average volumes.

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

| <b>Quarter ended March 31,</b>                           | <b>Volume</b>      | <b>2007 compared to<br/>2006<br/>Increase (decrease)<br/>Due to:<br/>Rate<br/>(In thousands)</b> | <b>Total</b>       |
|--|--------------------|--|--------------------|
| <b>Interest income on interest-earning assets:</b>       |                    |  |                    |
| Money market investments                                 | \$ (6,570)         | \$ 1,973   | \$ (4,597)         |
| Government obligations                                   | (681)              | (1,979)  | (2,660)            |
| Mortgage-backed securities                               | (3,479)            | (2,980)  | (6,459)            |
| Corporate bonds  | 39                 | 4  | 43                 |
| FHLB stock   | 113                | (441)  | (328)              |
| Equity securities  | (81)               | (131)  | (212)              |
| <b>Total investments</b>                                 | <b>(10,659)</b>    | <b>(3,554)</b>   | <b>(14,213)</b>    |
| Residential real estate loans                            | 6,225              | (1,005)  | 5,220              |
| Construction loans                                       | 3,950              | 1,054  | 5,004              |
| Commercial loans (1)                                     | (42,029)           | 15,608   | (26,421)           |
| Finance leases   | 1,771              | (246)  | 1,525              |
| Consumer loans   | 244                | (1,407)  | (1,163)            |
| <b>Total loans</b>                                       | <b>(29,839)</b>    | <b>14,004</b>  | <b>(15,835)</b>    |
| <b>Total interest income</b>                             | <b>(40,498)</b>    | <b>10,450</b>  | <b>(30,048)</b>    |
| <b>Interest expense on interest-bearing liabilities:</b> |                    |  |                    |
| Deposits   | (15,374)           | 18,681   | 3,307              |
| Other borrowed funds                                     | (17,089)           | 6,323  | (10,766)           |
| FHLB advances  | 3,119              | 900  | 4,019              |
| <b>Total interest expense</b>                            | <b>(29,344)</b>    | <b>25,904</b>  | <b>(3,440)</b>     |
| <b>Change in net interest income</b>                     | <b>\$ (11,154)</b> | <b>\$ (15,454)</b>   | <b>\$ (26,608)</b> |

(1) Decrease in volume relates primarily to the payment received of \$2.4 billion from a local financial institution to partially

extinguish a  
secured  
commercial loan  
during the  
second quarter  
of 2006.

A portion of the Corporation's interest-earning assets, mostly investments in obligations of some U.S. Government agencies and sponsored entities, generate interest which is exempt from income tax, principally in Puerto Rico. Also, interest and gains on sale of investments held by the Corporation's international banking entities are tax-exempt under Puerto Rico tax law. To facilitate the comparison of all interest data related to these assets, the interest income has been converted to a taxable equivalent basis. The tax equivalent yield was estimated by dividing the interest rate spread on exempt assets by (1 less the Puerto Rico statutory tax rate (39.0% for 2007 and 41.5% for 2006)) 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 of derivative instruments, the basis adjustment amortization or accretion, and unrealized gains or losses on SFAS 159 liabilities 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, the basis adjustment amortization or accretion, and unrealized gains or losses on SFAS 159 liabilities have no effect on interest due or interest earned on interest-bearing liabilities or interest-earning assets, respectively, or on interest payments exchanged with swap counterparties.

**Table of Contents**

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:

| <i>(In thousands)</i>  | <b>Quarter ended March 31,</b> |                |
|--|--------------------------------|----------------|
|  | <b>2007</b>                    | <b>2006</b>    |
| Interest income on interest earning assets on a tax equivalent basis | \$ 303,514                     | \$ 333,562     |
| Less: tax equivalent adjustments                                     | (3,988)                        | (10,840)       |
| Plus: net unrealized (loss) gain on derivatives                      | (941)                          | 4,983          |
| <br>Total interest income  | <br>\$ 298,585                 | <br>\$ 327,705 |

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

| <i>(In thousands)</i>  | <b>Quarter ended March</b> |                           |
|--|----------------------------|---------------------------|
|  | <b>2007</b>                | <b>31,</b><br><b>2006</b> |
| Unrealized (loss) gain on derivatives (economic undesignated hedges):        |                            |                           |
| Interest rate caps   | \$ (701)                   | \$ 3,320                  |
| Interest rate swaps on corporate bonds                                       |                            | 30                        |
| Interest rate swaps on loans   | (240)                      | 1,633                     |
| <br>Net unrealized (loss) gain on derivatives (economic undesignated hedges) | <br>\$ (941)               | <br>\$ 4,983              |

The following table summarizes the components of interest expense for the quarter ended March 31, 2007 and 2006. As previously stated, the net interest margin analysis excludes the changes in the fair value of derivatives, unrealized gains or losses on SFAS 159 liabilities, and the basis adjustment.

| <i>(In thousands)</i>   | <b>Quarter ended March 31,</b> |                |
|---|--------------------------------|----------------|
|   | <b>2007</b>                    | <b>2006</b>    |
| Interest expense on interest-bearing liabilities  | \$ 175,721                     | \$ 184,716     |
| Net interest incurred (realized) on interest rate swaps   | 3,840                          | (3,506)        |
| Amortization of placement fees on brokered CDs  | 2,144                          | 3,949          |
| Amortization of placement fees on medium-term notes   | 21                             | 7              |
| <br>Interest expense excluding net unrealized (gains) losses on derivatives (economic undesignated hedges), changes in the fair value of SFAS 159 liabilities, and accretion of basis adjustments | <br>181,726                    | <br>185,166    |
| Net unrealized (gains) losses on derivatives (economic undesignated hedges) and SFAS 159 liabilities  | (461)                          | 69,720         |
| Accretion of basis adjustment   | (115)                          |                |
| <br>Total interest expense  | <br>\$ 181,150                 | <br>\$ 254,886 |

**Table of Contents**

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

| <i>(In thousands)</i>  | <b>Quarter ended March 31,</b> |             |
|--|--------------------------------|-------------|
|  | <b>2007</b>                    | <b>2006</b> |
| Unrealized (gains) losses on derivatives (economic undesignated hedges):                             |                                |             |
| Interest rate swaps on brokered CDs  | \$ (19,627)                    | \$ 65,637   |
| Interest rate swaps and other derivatives on medium-term notes                                       | (165)                          | 4,083       |
| Net unrealized (gains) losses on derivatives (economic undesignated hedges)                          | \$ (19,792)                    | \$ 69,720   |
| Unrealized losses on SFAS 159 liabilities:   |                                |             |
| Unrealized loss on brokered CDs  | \$ 19,209                      | \$          |
| Unrealized loss on medium-term notes   | 122                            |             |
| Net unrealized losses on SFAS 159 liabilities  | \$ 19,331                      | \$          |
| Net unrealized (gains) losses on derivatives (economic undesignated hedges) and SFAS 159 liabilities | \$ (461)                       | \$ 69,720   |

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

| <i>(In thousands)</i>                    | <b>Quarter ended March</b> |                 |
|--|----------------------------|-----------------|
|  | <b>2007</b>                | <b>31, 2006</b> |
| Accretion of basis adjustment:           |                            |                 |
| Interest rate swaps on medium-term notes | \$ (115)                   | \$              |

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

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

Net interest incurred or realized on interest rate swaps primarily represents net interest exchanged on swaps that economically 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). For 2007 the amortization of broker placement fees relates to financial instruments not elected for the fair value option under SFAS 159.

Unrealized gains or losses on derivatives represent changes in the fair value of derivatives, primarily interest rate swaps, that economically hedge liabilities (i.e., brokered CDs and medium-term notes) or assets (i.e., loans and corporate bonds).

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

**Table of Contents**

The basis adjustment represents the basis differential between the market value and the book value of the \$150 million medium-term note recognized at the inception of fair value hedge accounting on April 3, 2006, as well as changes in fair value recognized after the inception until the discontinuance of fair value hedge accounting on January 1, 2007. The basis adjustment amortizes or accretes over the remaining life of the \$150 million medium-term note as a yield adjustment.

As shown on the tables above, the results of operations for the first quarter of 2007 and 2006 were impacted by changes in the valuation of interest rate swaps that hedge economically the Corporation's brokered CDs and medium-term notes and unrealized losses on SFAS 159 liabilities. The change in the valuation of interest rate swaps and unrealized losses on SFAS 159 liabilities, recorded as part of interest expense, resulted in a net unrealized gain of approximately \$0.5 million for the first quarter of 2007, compared to an unrealized loss of \$69.7 million for the first quarter of 2006.

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 (receive fixed/pay floating). Refer to the Risk Management Derivatives discussion 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.

First BanCorp's net interest income increased by \$44.6 million for the first quarter of 2007 compared to the same period in 2006. The increase in net interest income for the first quarter of 2007, as compared to the first quarter of 2006, was mainly driven by fluctuations in the valuation of derivative instruments and the adoption of SFAS 159, effective January 1, 2007, partially offset by a reduction in the Corporation's average interest-earning assets of \$2.6 billion, or 13%, and a compression in the net interest margin due to the flattening of the yield curve. For the first quarter of 2007, the change in the valuation of interest rate swaps coupled with unrealized losses on SFAS 159 liabilities recorded as part of interest expense resulted in net unrealized gains of approximately \$0.5 million compared to unrealized losses of \$69.7 million for the same period in 2006. During the first quarter of 2006, the Corporation reflected changes in the fair value of derivative instruments as non-hedging instruments, creating earnings volatility as a result of the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. With the adoption of SFAS 159, unrealized gains in the valuation of derivative instruments of \$19.8 million recorded as part of interest expense were partially offset by unrealized losses on SFAS 159 liabilities of \$19.3 million.

The decrease in average interest-earnings assets for the quarter ended March 31, 2007, compared to the same period a year ago, was mainly the result of a decrease in average loans of \$1.7 billion and a decrease of \$0.9 billion in average investments including money market instruments. The decrease in the Corporation's loan portfolio was primarily due to the repayment of approximately \$2.4 billion received from a local financial institution reducing the balance of certain secured commercial loan with the Corporation during the second quarter of 2006. The decrease in the investment portfolio resulted mainly from maturities and prepayments received from the Corporation's investment portfolio, principally mortgage-backed securities and the Corporation's decision to deleverage its investment portfolio.

On a tax equivalent basis, net interest income, excluding the changes in the fair value of derivative instruments, the basis adjustment amortization or accretion and unrealized losses on SFAS 159 liabilities, decreased by \$26.6 million or 18% for the first quarter of 2007, as compared to the same period in 2006. The

**Table of Contents**

decrease in tax equivalent net interest income was principally due to significant decreases in the average volume of interest-earning assets coupled with margin compressions due to the continuous flattening of the yield curve and fluctuations in net interest settlements on interest rate swaps. First BanCorp's net interest spread and margin on a tax equivalent basis for the first quarter of 2007 were 2.38% and 2.94%, respectively, compared to 2.66% and 3.11%, respectively, for the same period in 2006. The decrease in the net interest rate spread and margin during 2007 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, other than short-term money market investments (allocating a funding cost equal to the weighted-average cost of the Corporation's other borrowed funds), was approximately 0.38% for the quarter ended March 31, 2007, compared to 1.32% for the same period in 2006. The tax equivalent yield on interest-earning assets increased by 35 basis points during the first quarter of 2007, compared to the same period in 2006, 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, to the re-pricing of short-term investments, mainly money market instruments, 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 63 basis points during the first quarter of 2007 when compared to same period in 2006, 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 change in net payments on interest rate swaps included as part of interest expense. For the quarter ended March 31, 2007, the net settlement payments on such interest rate swaps resulted in additional charges of \$3.8 million to interest expenses, or a net increase of \$7.3 million in interest expense compared to the same period in 2006, as the rates under the variable leg of the swaps exceeded the rates received.

**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 and lease loss experience, current economic conditions, the fair value of the underlying collateral and the financial condition of the borrowers, and, as such, includes amounts based on judgments and estimates made by the Corporation. Although the Corporation believes that the allowance for loan and lease losses is adequate, factors beyond the Corporation's control, including factors affecting the economies of Puerto Rico, the United States, the U.S. Virgin Islands and the British Virgin Islands may contribute to delinquencies and defaults, thus necessitating additional reserves.

For the quarter ended March 31, 2007, the Corporation provided \$24.9 million for loan and lease losses, as compared to \$19.4 million, for the same period in 2006.

Refer to the discussion under "Credit Risk Management" below for an analysis of the allowance for loan and lease losses and non-performing assets and related ratios.

First BanCorp's provision for loan and lease losses for the first quarter of 2007 increased by \$5.5 million or 29% compared to the same period in 2006. The increase in the provision principally reflects growth in the Corporation's commercial loan portfolios, other than secured commercial loans to local financial institutions coupled with increasing trends in non-accruing loans and charge-offs experienced during 2007 compared to the first



**Table of Contents**

quarter of 2006. At March 31, 2007, the Corporation's non-accruing loans amounted to \$260.0 million, an increase of \$87.7 million, or 51%, compared to non-accruing loans outstanding at March 31, 2006. The increase was mainly due to increases in delinquencies in 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 in a midst of a recession. The 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 utility 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 first quarter of 2007 were \$21.8 million, or 0.78% of average loans on an annualized basis, as compared to \$14.8 million, or 0.46% of average loans on an annualized basis, for the comparable period in 2006. The increase in net charge-offs for 2007, compared to 2006, was mainly associated with consumer loans and leases collateralized by motor vehicles as well as commercial loans driven by increased delinquency levels. Recoveries made from previously written-off accounts were \$1.4 million for the first quarter of 2007, compared to \$1.7 million for the same period in 2006. The Corporation's net charge-offs were also affected by the deteriorating economic conditions in Puerto Rico discussed above.

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

| <i>(In thousands)</i>   | <b>Quarter ended<br/>March 31,</b> |                  |
|---|------------------------------------|------------------|
|   | <b>2007</b>                        | <b>2006</b>      |
| Other service charges on loans  | \$ 1,791                           | \$ 1,486         |
| Service charges on deposit accounts   | 3,191                              | 3,277            |
| Mortgage banking activities gain (loss)   | 762                                | (575)            |
| Rental income   | 664                                | 773              |
| Insurance income  | 2,949                              | 3,057            |
| Other commissions and fees  | 61                                 | 80               |
| Other operating income  | 3,247                              | 3,199            |
| Non-interest income before net (loss) gain on investments, net gain on partial extinguishment and recharacterization of secured commercial loans to a local financial institution and gain on sale of credit card portfolio | 12,665                             | 11,297           |
| Net (loss) gain on sale of investments  | (732)                              | 1,424            |
| Impairment on investments   | (1,427)                            | (2,133)          |
| Net loss on investments   | (2,159)                            | (709)            |
| Net gain on partial extinguishment and recharacterization of secured commercial loans to a local financial institution  | 2,497                              |                  |
| Gain on sale of credit card portfolio   | 2,819                              |                  |
| <b>Total</b>  | <b>\$ 15,822</b>                   | <b>\$ 10,588</b> |

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

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

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

Income from mortgage banking activities includes gains on 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 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 U.S. 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.

**Table of Contents**

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

First BanCorp's non-interest income for the first quarter of 2007 increased by \$5.2 million, or 49%, compared to the same period in 2006. The increase in non-interest income for the first quarter of 2007, compared to the first quarter of 2006, was mainly due to a \$2.8 million gain on the sale of the Corporation's credit card portfolio and a \$2.5 million gain on the partial extinguishment and recharacterization of certain secured commercial loan extended to a local financial institution coupled with higher earnings in the mortgage banking activities offset in part by losses on sale of investments.

The gain on the sale of the Corporation's credit card portfolio during the first quarter of 2007 results from portfolios sold pursuant to a strategic alliance agreement reached with a U.S. financial institution in 2003. There were no such sales during the first quarter of 2006.

During the first quarter of 2007, the Corporation entered into various agreements with R&G Financial relating to prior transactions accounted for as commercial loans secured by mortgage loans and pass-through trust certificates from R&G Financial subsidiaries. First, through a mortgage payment agreement, R&G Financial paid the Corporation approximately \$50 million to reduce the commercial loan that R&G Premier Bank, R&G Financial's banking subsidiary, had outstanding with the Corporation. In addition, the remaining balance of \$271 million was re-documented as a secured loan from the Corporation to R&G Financial. Second, R&G Financial and the Corporation amended various agreements involving, as of the date of the transaction, approximately \$183.8 million of securities collateralized by loans that were originally sold through five grantor trusts. The modifications to the original agreements allow the Corporation to treat these transactions as true sales for accounting and legal purposes. As a result of the agreements and the partial extinguishment of the secured commercial loan, the Corporation recorded a net gain of \$2.5 million related to the difference between the carrying value of the loans and the net payment and the fair value of the securities received from R&G Financial.

Income from mortgage banking activities for the first quarter of 2007 resulted in a gain of \$0.8 million compared to a loss of \$0.6 million for the first quarter of 2006. The increase for 2007 compared to 2006 was mainly due to a higher volume of mortgage loan sales coupled with variances in valuation adjustments to the Corporation's loans held for sale portfolio. For the first quarter of 2006, the Corporation recorded a \$1.0 million lower-of-cost-or-market negative valuation adjustment to the Corporation's loans held for sale portfolio as a result of increases in long-term interest rates. There were no such charges for the comparable period in 2007.

Service charges on deposit accounts and loans for the first quarter of 2007 increased by \$0.2 million or 5% compared to the same period in 2006. The increase for 2007 primarily reflects higher service charges on credit card related activities due to a larger volume of accounts and transactions.

For the first quarter of 2007, the Corporation recognized a net loss on investment securities of \$2.2 million, compared to a loss of \$0.7 million for the same period in 2006. The increase in net loss on investments securities in 2007 was the result of realized losses on the sale of certain equity securities of approximately \$0.7 million compared to realized gains of \$1.4 million recognized during the same period in 2006, partially offset by a decrease of \$0.7 million in other-than-temporary impairment charges related to similar equity securities in the Corporation's available-for-sale portfolio.

**Table of Contents****Non-Interest Expenses**

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

| <i>(In thousands)</i>                       | <b>Quarter ended<br/>March 31,</b> |                  |
|---|------------------------------------|------------------|
|   | <b>2007</b>                        | <b>2006</b>      |
| Employees compensation and benefits         | \$ 36,372                          | \$ 34,125        |
| Occupancy and equipment                     | 14,382                             | 12,706           |
| Deposit insurance premium                   | 356                                | 399              |
| Other taxes, insurance and supervisory fees | 4,917                              | 3,857            |
| Professional fees recurring                 | 3,402                              | 2,337            |
| Professional fees non-recurring             | 2,995                              | 5,056            |
| Servicing and processing fees               | 1,719                              | 2,181            |
| Business promotion                          | 4,930                              | 3,774            |
| Communications                              | 2,228                              | 2,456            |
| Other                                       | 8,063                              | 4,847            |
| <b>Total</b>                                | <b>\$ 79,364</b>                   | <b>\$ 71,738</b> |

The Corporation's non-interest expenses for the first quarter of 2007 increased by \$7.6 million, or 11%, compared to the first quarter of 2006. The increase in non-interest expenses for 2007 was mainly due to increases in employees compensation and benefits, other taxes, insurance and supervisory fees, occupancy and equipment expenses, business promotion and other expenses, partially offset by a decrease in professional service fees.

Employees compensation and benefits expenses for the first quarter of 2007 increased by \$2.2 million, or 7%, compared to the same period in 2006. The increase in employees compensation and benefits expense was attributable to increases in the average compensation and related fringe benefits paid to employees and an increase in the employees headcount. The increase in the headcount was mostly attributable to increases associated with the Corporation's loan originations and deposit gathering efforts, in particular in First Bank Puerto Rico ( First Bank or the Bank ), FirstBank Florida, First Mortgage, 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. For the first quarter of 2007, compensation and benefits expense includes an increase of \$0.6 million to support the growth of FirstBank Florida.

Other taxes, insurance and supervisory fees for the first quarter of 2007 increased by \$1.1 million, or 27%, compared to the first quarter of 2006. During 2007, the Corporation expensed a higher amount of prepaid municipal and property taxes as compared to 2006.

Occupancy and equipment expenses for the first quarter of 2007 increased by \$1.7 million, or 13%, compared to the first quarter of 2006. The increase in occupancy and equipment expenses in 2007 as compared to 2006 was mainly due to increases in depreciation, maintenance, rent and repair expenses associated with the expansion of the Corporation's branch network and loan origination offices, including FirstBank Florida.

Business promotion expenses increased during the first quarter of 2007 by \$1.2 million, or 31%, compared to the first quarter of 2006. The Corporation maintains active campaigns for its loan and deposit products. The Puerto Rico financial services market is highly competitive and requires investment in marketing efforts.

Other expenses increased during the first quarter of 2007 by \$3.2 million, or 66%, compared to the same period in 2006. The increase in other expenses was mainly due to a \$2.0 million increase in legal reserves resulting

**Table of Contents**

from management's assessment of the probable and estimable loss based on new information available.

Professional fees decreased for the first quarter of 2007 by \$1.0 million, or 13%, compared to the first quarter of 2006. The decrease for 2007 was primarily attributed to lower legal, accounting and consulting fees due to the conclusion during the third quarter of 2006 of the internal review conducted by the Corporation's Audit Committee and the restatement process, partially offset by higher expenses associated with other related legal and regulatory proceedings.

**Provision for Income Tax**

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

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

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

For the quarter ended March 31, 2007, the Corporation recognized an income tax expense of \$6.1 million, compared to an income tax benefit of \$11.6 million recognized for the same period in 2006. The fluctuation in the provision for income tax for the first quarter of 2007, compared to the same period in 2006, was mainly due to a decrease in deferred income tax benefits, resulting principally from unrealized gains on derivative instruments and the adoption of SFAS 159, partially offset by a decrease in the current tax provision. During the first quarter of 2006, the Corporation reflected changes in the fair value of derivative instruments as non-hedging instruments through operations recording unrealized losses of \$69.7 million for change in fair values of derivatives recorded as part of interest expense. The adoption of SFAS 159 reduced the earnings volatility that previously resulted from the accounting asymmetry created by accounting for the financial liabilities at amortized cost and the derivatives at fair value. With the adoption of SFAS 159, changes in the fair value of derivative instruments recorded as part of interest expense (an unrealized gain of \$19.8 million) were partially

**Table of Contents**

offset by an unrealized loss on SFAS 159 liabilities of \$19.3 million. For the first quarter of 2007, the Company recognized a deferred income tax benefit of \$2.3 million compared to a deferred income tax benefit of \$28.6 million for the same period in 2006.

The current provision for income taxes for the first quarter of 2007 amounted to \$8.4 million compared to \$17.1 million for the first quarter of 2006, a decrease of \$8.7 million. The decrease in the current income tax provision for the first quarter of 2007 is mainly attributable to lower taxable income.

As of March 31, 2007, the Corporation evaluated its ability to realize the deferred tax asset and concluded, based on the evidence available, that it is more likely than not that some of the deferred tax asset will not be realized and thus, established a valuation allowance amounting to \$6.0 million as of March 31, 2007, compared to a valuation allowance of \$6.1 million at December 31, 2006. As of March 31, 2007, the deferred tax asset, net of the valuation allowance, amounted to approximately \$110.3 million compared to \$162.1 million at December 31, 2006.

**Table of Contents****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.

Total loan production for the quarter ended March 31, 2007 was \$974.8 million, a decrease of \$420.3 million, or 30%, compared to the same period in 2006. The decrease in loan production during 2007 was mainly due to decreases in residential real estate, commercial, and consumer loan originations which were negatively impacted by higher prevailing interest rates, worsening economic conditions in Puerto Rico, and stricter underwriting guidelines.

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

| <i>(In thousands)</i>       | <b>March 31,<br/>2007</b> | <b>March 31,<br/>2006</b> |
|-----------------------------|---------------------------|---------------------------|
| Residential real estate     | \$ 168,339                | \$ 277,943                |
| Commercial and construction | 585,927                   | 847,853                   |
| Finance leases              | 47,172                    | 47,209                    |
| Consumer                    | 173,315                   | 222,078                   |
| <br>Total loan production   | <br>\$ 974,753            | <br>\$1,395,083           |

*Residential Real Estate Loans*

Residential mortgage loan production for the quarter ended March 31, 2007 amounted to \$168.3 million, a decrease of \$109.6 million, or 39%, compared to the quarter ended March 31, 2006. The decrease in mortgage loan production for 2007, compared to 2006, was mainly attributable to deteriorating economic conditions in Puerto Rico and stricter underwriting standards. In May 2006, the Corporation decided to make certain adjustments to its underwriting standards designed to enhance the credit quality of its mortgage loan portfolio, in light of worsening 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 17% of total loans originated and purchased for the quarter ended March 31, 2007. The Corporation's strategy is to penetrate markets by providing customers with a variety of high quality mortgage products. The Corporation's residential mortgage loan originations continued to be driven by FirstMortgage, 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. 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 focuses on building relationships with realtors by providing resources, office amenities and personnel, to assist real estate brokers in building their individual businesses and closing transactions. FirstMortgage multi-channel strategy has proven to be effective in capturing business.

**Table of Contents***Commercial and Construction Loans*

Commercial and construction loan production for the quarter ended March 31, 2007 amounted to \$585.9 million, a decrease of \$261.9 million, or 31%, compared to the same period a year ago. The decrease in 2007 compared to 2006 was mainly due to adverse economic conditions in Puerto Rico and in the South Florida market and the implementation of stricter underwriting standards. According to the Puerto Rico Planning Board, Puerto Rico is in a midst of a recession, causing a slowdown in commercial business activity. In addition, market data during 2007 suggested that the South Florida market was weakening, causing deterioration in the Corporation's commercial and construction activities in the continental United States.

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 four 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 quarter ended March 31, 2007 amounted to \$173.3 million, a decrease of \$48.8 million, or 22%, compared to originations for the same period in 2006. The decrease in consumer loan originations for 2007 compared to 2006 was mainly due to adverse economic conditions in Puerto Rico.

*Finance Leases*

For each of the quarters ended March 31, 2007 and 2006, finance leases originations, which are mostly composed of loans to individuals to finance the acquisition of a motor vehicle, amounted to \$47.2 million.

**Assets**

Total assets at March 31, 2007 amounted to \$17.2 billion, a decrease of \$195.3 million compared to total assets of \$17.4 billion at December 31, 2006. The decrease in total assets at March 31, 2007 compared to total assets at December 31, 2006 was mainly the result of a decrease in the investment securities portfolio, as well as a decrease in the Corporation's deferred tax asset, partially offset by an increase in money market instruments.

Notwithstanding the recognition, as of March 31, 2007, of securities collateralized by loans with a fair market value of \$176.4 million, obtained as part of the execution of various agreements entered into with R&G Financial, the Corporation's investment portfolio decreased by \$31.6 million as compared to the balance as of December 31, 2006. The decrease in investment securities resulted from maturities and prepayments received from the Corporation's investment portfolio, principally 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 previously discussed, during the first quarter of 2007, the Corporation entered into various agreements with R&G Financial relating to prior transactions accounted for as commercial loans secured by mortgage loans and pass-through trust certificates by the Corporation. As part of the agreements, R&G Financial paid down \$50 million of the secured commercial loan that R&G Financial had outstanding and various agreements involving, as of the date of the transaction, approximately \$183.8 million of secured commercial loans secured by trust certificates were amended to treat these transactions as "true sale" for accounting and legal purposes. The



**Table of Contents**

execution of the agreements caused a decrease in the Corporation's loan portfolio and an increase in the Corporation's investment securities portfolio.

The decrease in the deferred tax asset was the tax impact related with the adoption of SFAS 159 on January 1, 2007, of approximately \$58.7 million.

**Loan Portfolio**

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

| <i>(In thousands)</i>   | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|---------------------------|------------------------------|
| Residential real estate loans   | \$ 2,853,213              | \$ 2,772,630                 |
| Commercial loans:   |                           |                              |
| Construction loans  | 1,454,715                 | 1,511,608                    |
| Commercial real estate loans  | 1,286,425                 | 1,215,040                    |
| Commercial loans  | 2,730,122                 | 2,698,141                    |
| Loans to local financial institutions collateralized by real estate mortgages and pass-through trust certificates | 679,720                   | 932,013                      |
| Commercial loans  | 6,150,982                 | 6,356,802                    |
| Finance leases  | 377,900                   | 361,631                      |
| Consumer and other loans  | 1,742,331                 | 1,772,917                    |
| Total loans   | \$ 11,124,426             | \$ 11,263,980                |

At March 31, 2007, the Corporation's total loans decreased by \$139.6 million, when compared with the balance as of December 31, 2006. The decrease in the Corporation's total loans primarily relates to the previously discussed agreements with R&G Financial that enabled the Corporation to recharacterize certain secured commercial loans as securities collateralized by loans coupled with a decrease in construction loans, partially offset with increases in commercial and residential real estate loans.

*Residential Real Estate Loans*

As of March 31, 2007, the Corporation's residential real estate loan portfolio increased by \$80.6 million as compared to the balance as of December 31, 2006. The Corporation has diversified its loan portfolio by increasing the concentration of residential real estate loans. The Corporation's residential real estate loans are mainly composed of fully amortizing fixed-rated loans. In accordance with the Corporation's underwriting guidelines, residential real estate loans are mostly fully documented loans and the Corporation is not actively involved in the origination of negative amortization loans or option Adjustable Rate Mortgage loans.

*Commercial and Construction Loans*

As of March 31, 2007, the Corporation's commercial loan portfolio decreased by \$205.8 million compared to the balance as of December 31, 2006. The decrease was mainly due to the aforementioned agreements with R&G Financial that reduced the Corporation's secured commercial loans extended to local financial institutions. The commercial loan portfolio, other than loans extended to local financial institutions, increased by \$46.5 million. The Corporation strategy focuses on growing its commercial loan portfolio principally through commercial real

**Table of Contents**

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 \$411.8 million in one mortgage originator in Puerto Rico, Doral Financial Corporation (Doral), at March 31, 2007. The Corporation had outstanding \$267.9 million with another mortgage originator in Puerto Rico, R&G Financial, for total loans to mortgage originators amounting to \$679.7 million at March 31, 2007. These commercial loans are secured by individual mortgage loans on residential and commercial real estate. In December 2005, the Corporation obtained a waiver from the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico with respect to the statutory limit for individual borrowers (loans-to-one borrower limit). In May 2006, the Corporation received a payment from Doral of approximately \$2.4 billion, substantially reducing the balance of the secured commercial loan extended 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.

As previously discussed, the execution of the agreements entered into with R&G Financial during the first quarter of 2007 enabled First BanCorp to fulfill the remaining requirement of the Consent Order signed with banking regulators relating to the mortgage-related transactions with R&G Financial that First BanCorp accounted for as commercial loans secured by the mortgage loans and pass-through trust certificates.

*Consumer Loans*

At March 31, 2007, the Corporation's consumer loan portfolio decreased by \$30.6 million, as compared to the portfolio balance at December 31, 2006. The decrease is mainly driven by the sale of approximately \$15.6 million during the first quarter of 2007 of the Corporation's credit card portfolio pursuant to a strategic alliance agreement reached with a U.S. financial institution in 2003, coupled with decreases in the Corporation's auto loan portfolio due to lower originations.

*Finance Leases*

At March 31, 2007, finance leases, which are mostly composed of loans to individuals to finance the acquisition of a motor vehicle, increased by \$16.3 million as compared to the portfolio balance as of December 31, 2006. 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, excluding money market investments, amounted to \$5.1 billion, at March 31, 2007, a decrease of \$31.6 million, when compared with the investment portfolio at December 31, 2006. The decrease in investment securities at March 31, 2007, compared to the balance at December 31, 2006, was mainly 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 and government obligations, partially offset by the previously discussed agreements with R&G Financial that increased the Corporation's mortgage-backed securities portfolio. The Corporation's decision to deleverage its investment portfolio was influenced, among other things, by the flat-to-inverted yield curve.

**Table of Contents**

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

| <i>(In thousands)</i>                     | <b>March 31,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|---------------------------|----------------------------------|
| Money market investments                  | \$ 476,814                | \$ 456,470                       |
| Investment securities held-to-maturity:   |                           |                                  |
| U.S. Government and agencies obligations  | 2,143,284                 | 2,258,040                        |
| Puerto Rico Government obligations        | 31,859                    | 31,716                           |
| Mortgage-backed securities                | 1,008,867                 | 1,055,375                        |
| Corporate bonds                           | 2,000                     | 2,000                            |
|   | 3,186,010                 | 3,347,131                        |
| Investment securities available-for-sale: |                           |                                  |
| U.S. Government and agencies obligations  | 405,031                   | 403,592                          |
| Puerto Rico Government obligations        | 25,427                    | 25,302                           |
| Mortgage-backed securities                | 1,387,174                 | 1,253,853                        |
| Corporate bonds                           | 4,895                     | 4,961                            |
| Equity securities                         | 5,965                     | 12,715                           |
|   | 1,828,492                 | 1,700,423                        |
| Other equity securities                   | 41,592                    | 40,159                           |
| Total investments                         | \$ 5,532,908              | \$ 5,544,183                     |

Mortgage-backed securities at the indicated dates consist of:

| <i>(In thousands)</i>              | <b>March 31,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|------------------------------------|---------------------------|----------------------------------|
| Held-to-maturity:                  |                           |                                  |
| FHLMC certificates                 | \$ 13,934                 | \$ 15,438                        |
| FNMA certificates                  | 994,933                   | 1,039,937                        |
|                                    | 1,008,867                 | 1,055,375                        |
| Available-for-sale:                |                           |                                  |
| FHLMC certificates                 | 7,069                     | 7,575                            |
| GNMA certificates                  | 363,134                   | 374,368                          |
| FNMA certificates                  | 840,185                   | 871,540                          |
| Mortgage pass-through certificates | 176,786                   | 370                              |

|                                  |              |              |
|----------------------------------|--------------|--------------|
|                                  | 1,387,174    | 1,253,853    |
| Total mortgage-backed securities | \$ 2,396,041 | \$ 2,309,228 |

**Table of Contents**

The carrying values of investment securities (excluding other equity securities) at March 31, 2007, by contractual maturity (excluding mortgage-backed securities, equity securities and money market investments) are shown below:

| <i>(In thousands)</i>   | <b>Carrying<br/>amount</b> | <b>Weighted<br/>average<br/>yield<br/>%</b> |
|---|----------------------------|---|
| U.S. Government and agencies obligations                            |                            |   |
| Due within one year   | \$ 59,697                  | 5.07  |
| Due after five years through ten years                              | 392,115                    | 4.30  |
| Due after ten years   | 2,096,503                  | 5.83  |
|   | 2,548,315                  | 5.58  |
| <br>  |                            |   |
| Puerto Rico Government obligations                                  |                            |   |
| Due after one year through five years                               | 5,337                      | 6.23  |
| Due after five years through ten years                              | 32,116                     | 5.37  |
| Due after ten years   | 19,833                     | 5.59  |
|   | 57,286                     | 5.53  |
| <br>  |                            |   |
| Corporate bonds   |                            |   |
| Due after five years through ten years                              | 1,209                      | 7.70  |
| Due after ten years   | 5,686                      | 7.21  |
|   | 6,895                      | 7.30  |
| <br>  |                            |   |
| Total   | 2,612,496                  | 5.58  |
| <br>  |                            |   |
| Mortgage-backed securities  | 2,396,041                  | 4.91  |
| Equity securities   | 5,965                      | 0.03  |
| <br>  |                            |   |
| Total investment securities-available-for-sale and held-to-maturity | \$ 5,014,502               | 5.25  |

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 March 31, 2007, total liabilities amounted to \$15.9 billion, a decrease of \$294.5 million as compared to the balance as of December 31, 2006. The decrease of total liabilities as of March 31, 2007, compared to the balance as of December 31, 2006, was mainly the result of a \$524.4 million decrease in federal funds purchased and securities sold under repurchased agreements partially offset by a \$274.5 million increase in deposits. The

**Table of Contents**

decrease in federal funds purchased and securities sold under repurchased agreements was mainly attributable to the Corporation's decision to deleverage its investment portfolio.

The increase in deposits as of March 31, 2007, compared to the balance as of December 31, 2006, was mainly due to increases in brokered CDs. The use of brokered CDs has been particularly important for 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 is 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 \$8.4 billion at March 31, 2007. At March 31, 2007, brokered CDs amounted to \$7.6 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 March 31, 2007:

| <i>(In thousands)</i>           | <b>Total</b>        |
|---------------------------------|---------------------|
| Three months or less            | \$ 816,875          |
| Over three months to six months | 983,207             |
| Over six months to one year     | 897,328             |
| Over one year to five years     | 1,396,670           |
| Over five years                 | 3,456,148           |
| <b>Total</b>                    | <b>\$ 7,550,228</b> |

The Corporation maintains unsecured lines of credit with other banks. At March 31, 2007, the Corporation's total unused lines of credit with these banks amounted to \$315.0 million. At March 31, 2007, the Corporation had an available line of credit with the FHLB, guaranteed with excess collateral pledged to the FHLB in the amount of \$676.5 million.

The Corporation's deposit products include regular savings accounts, demand deposit accounts, money market accounts, CDs, and brokered CDs. Refer to Note 10 Deposits in the accompanying notes to the unaudited interim consolidated financial statements for further details. Total deposits amounted to \$11.3 billion at March 31, 2007, compared to \$11.0 billion at December 31, 2006. The increase in total deposits for 2007, compared to 2006, was mainly due to increases in brokered CDs.

Refer to Net Interest Income discussion above for information about averages balance of interest-bearing deposits, and the average interest rate paid on deposits for the quarters ended March 31, 2007 and 2006.

**Capital**

The Corporation's stockholders' equity amounted to \$1.3 billion at March 31, 2007, an increase of \$99.2 million compared to the balance as of December 31, 2006. The increase in stockholders' equity for the first quarter of 2007 is mainly composed of after-tax adjustments to beginning retained earnings of approximately \$91.8 million as part of the adoption of SFAS 159 and net income of \$22.8 million for the first quarter of 2007, partially offset by cash dividends of \$15.9 million paid during the first quarter of 2007.

**Table of Contents**

On August 27, 2007, the Corporation announced the completion of its sale of 9.250 million shares of First BanCorp's common stock to the Bank of Nova Scotia ( Scotiabank ) in a private placement. Scotiabank paid a purchase price of \$10.25 per First BanCorp's common share, for a total purchase price of approximately \$94.8 million. Scotiabank acquired 10% of First BanCorp's outstanding common shares as of the close of the transaction. As of August 31, 2007, First BanCorp had 92,504,056 common shares outstanding.

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

|   | <b>Banking Subsidiaries</b> |                  |                |                                   |
|---|-----------------------------|------------------|----------------|-----------------------------------|
|   | <b>First<br/>BanCorp</b>    | <b>FirstBank</b> | <b>Florida</b> | <b>To be well<br/>capitalized</b> |
| <b>As of March 31, 2007</b>                                   |                             |                  |                |                                   |
| Total capital (Total capital to risk-weighted assets)         | 13.78%                      | 13.82%           | 11.03%         | 10.00%                            |
| Tier 1 capital ratio (Tier 1 capital to risk-weighted assets) | 12.59%                      | 12.59%           | 10.64%         | 6.00%                             |
| Leverage ratio (1)  | 8.85%                       | 8.71%            | 8.04%          | 5.00%                             |
| <b>As of December 31, 2006</b>                                |                             |                  |                |                                   |
| Total capital (Total capital to risk-weighted assets)         | 12.46%                      | 12.25%           | 11.35%         | 10.00%                            |
| Tier 1 capital ratio (Tier 1 capital to risk-weighted assets) | 11.27%                      | 11.02%           | 10.96%         | 6.00%                             |
| Leverage ratio (1)  | 7.97%                       | 7.76%            | 8.10%          | 5.00%                             |

(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.

Effective January 1, 2007, the Corporation early adopted the provisions of SFAS 157 and SFAS 159. Refer to Notes 1 and 14 of the accompanying unaudited consolidated financial statements 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.

**Dividends**

For each of the quarters ended on March 31, 2007 and 2006, the Corporation declared cash dividends of \$0.07, per common share. Total cash dividends paid on common shares for each of the quarters ended on March 31, 2007 amounted to \$5.8 million. Dividends declared on preferred stock amounted to approximately \$10.1 million for each of the quarters ended on March 31, 2007 and 2006.



**Off-Balance Sheet Arrangements**

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

**Table of Contents**

As a provider of financial services, the Corporation routinely 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 March 31, 2007, commitments to extend credit and commercial and financial standby letters of credit amounted to approximately \$1.9 billion and \$100.0 million, respectively. Commitments to extend credit are agreements to lend to customers as long as the conditions established in the contract are met. Generally, the Corporation's mortgage banking activities do not enter into interest rate lock agreements with its prospective borrowers.

**Contractual Obligations and Commitments**

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

**Contractual Obligations and Commitments**  
**As of March 31, 2007**  
(In thousands)

|  | <b>Total</b>         | <b>Less than<br/>1 year</b> | <b>1-3 years</b>    | <b>3-5 years</b>  | <b>After 5<br/>years</b> |
|--|----------------------|-----------------------------|---------------------|-------------------|--------------------------|
| Contractual obligations <sup>(1)</sup> :                                   |                      |                             |                     |                   |                          |
| Certificates of deposit  | \$ 9,149,609         | \$ 4,032,098                | \$ 1,233,227        | \$ 427,544        | \$ 3,456,740             |
| Federal funds purchased and securities sold under agreements to repurchase | 3,163,304            | 2,075,804                   | 387,500             | 100,000           | 600,000                  |
| Advances from FHLB   | 590,000              | 35,000                      | 514,000             | 41,000            |                          |
| Notes payable  | 182,636              |                             |                     | 16,258            | 166,378                  |
| Other borrowings   | 231,743              |                             |                     |                   | 231,743                  |
| <b>Total contractual obligations</b>                                       | <b>\$ 13,317,292</b> | <b>\$ 6,142,902</b>         | <b>\$ 2,134,727</b> | <b>\$ 584,802</b> | <b>\$ 4,454,861</b>      |
| Commitments to sell mortgage loans   | \$ 73,455            | \$ 73,455                   |                     |                   |                          |
| Standby letters of credit  | \$ 100,018           | \$ 100,018                  |                     |                   |                          |
| Commitments to extend credit:  |                      |                             |                     |                   |                          |
| Lines of credit  | \$ 1,364,608         | \$ 1,364,608                |                     |                   |                          |
| Letters of credit  | 47,902               | 47,902                      |                     |                   |                          |
| Commitments to originate loans   | 500,780              | 500,780                     |                     |                   |                          |
| <b>Total commercial commitments</b>  | <b>\$ 1,913,290</b>  | <b>\$ 1,913,290</b>         |                     |                   |                          |

(1) \$29.0 million of tax liability associated with unrecognized tax benefits

under FIN 48  
has been  
excluded due to  
the high degree  
of uncertainty  
regarding the  
timing of future  
cash outflows  
associated with  
such  
obligations.

The Corporation has obligations and commitments to make future payments under contracts, such as debt, and 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 obligations since December 31, 2006.

**Table of Contents**

**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) reputational risk, and (8) contingency risk. First BanCorp has adopted policies and procedures 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.

The Corporation's risk management policies are described below as well as in the Management Discussion and Analysis of Financial Condition and Results of Operations section of First BanCorp's 2006 Annual Report on Form 10-K.

***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 ( 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 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.

**Table of Contents**

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 composition of the Corporation's interest-earning assets and interest-bearing liabilities since the end of 2006. As a consequence, the Corporation's interest rate risk profile has not changed significantly since December 31, 2006. During the first half of 2007, the Corporation began a process to improve its interest rate risk measurement practices. This process includes refinements and enhancements to the methodology used to measure the Corporation's interest rate risk, as well as the implementation of a third party software to measure the Corporation's interest rate risk profile.

*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 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.

**Table of Contents**

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

|  | <b>Notional amounts</b>             |  |
|--|-------------------------------------|--|
|  | <b>As of<br/>March 31,<br/>2007</b> | <b>As of<br/>December 31,<br/>2006</b> |
|  | <b>(In thousands)</b>               |  |
| Interest rate swap agreements:         |                                     |  |
| Pay fixed versus receive floating      | \$ 80,676                           | \$ 80,720                              |
| Receive fixed versus pay floating      | 4,777,161                           | 4,802,370                              |
| Embedded written options               | 13,515                              | 13,515                                 |
| Purchased options                      | 13,515                              | 13,515                                 |
| Written interest rate cap agreements   | 128,090                             | 125,200                                |
| Purchased interest rate cap agreements | 315,817                             | 330,607                                |
|  | <b>\$ 5,328,774</b>                 | <b>\$ 5,365,927</b>                    |

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

|   | <b>Notional amounts</b>             |  |
|---|-------------------------------------|--|
|   | <b>As of<br/>March 31,<br/>2007</b> | <b>As of<br/>December<br/>31,<br/>2006</b> |
|   | <b>(In thousands)</b>               |  |
| Economic undesignated hedges:   |                                     |  |
| Interest rate swaps used to hedge fixed rate certificates of deposit, notes payable and loans | \$ 4,857,837                        | \$ 336,473                                 |
| Embedded options on stock index deposits  | 13,515                              | 13,515                                     |
| Purchased options used to manage exposure to the stock market on embedded stock index options | 13,515                              | 13,515                                     |
| Written interest rate cap agreements  | 128,090                             | 125,200                                    |
| Purchased interest rate cap agreements  | 315,817                             | 330,607                                    |
| Total derivatives not designated as hedges  | <b>\$ 5,328,774</b>                 | <b>\$ 819,310</b>                          |
| Designated hedges:  |                                     |  |
| Fair value hedges:  |                                     |  |
| Interest rate swaps used to hedge fixed-rate certificates of deposit                          | \$                                  | \$ 4,381,175                               |
| Interest rate swaps used to hedge fixed- and step-rate notes payable                          |                                     | 165,442                                    |
| Total fair value hedges   | <b>\$</b>                           | <b>\$ 4,546,617</b>                        |
| Total   | <b>\$ 5,328,774</b>                 | <b>\$ 5,365,927</b>                        |



**Table of Contents**

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

| (In thousands)   | <b>Quarter ended<br/>March 31, 2007</b> |
|--|---|
| Fair value of contracts outstanding at the beginning of the period | \$ (126,778)                            |
| Contracts realized or otherwise settled during the period          | 74                                      |
| Changes in fair value during the period                            | 18,777                                  |
| Fair value of contracts outstanding at March 31, 2007              | \$ (107,927)                            |

**Source of Fair Value**

| (In thousands)                      | Payments Due by Period                  |                          |                          |                                     |                     |
|-------------------------------------|---|--------------------------|--------------------------|-------------------------------------|---------------------|
|                                     | Maturity<br>Less<br>Than<br>One<br>Year | Maturity<br>1-3<br>Years | Maturity<br>3-5<br>Years | Maturity<br>In Excess<br>of 5 Years | Total<br>Fair Value |
| <b>As of March 31, 2007</b>         |   |                          |                          |                                     |                     |
| Prices provided by external sources | \$ (386)                                | \$ (2,575)               | \$ (4,623)               | \$ (100,343)                        | \$ (107,927)        |

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 callable brokered CDs and medium-term notes. The long-haul method requires periodic assessment of hedge effectiveness and measurement of ineffectiveness. The ineffectiveness results to the extent the changes in the fair value of the derivatives do not offset the changes in fair value of the hedged liabilities due to changes in the hedged risks. Prior to the implementation of fair value hedge accounting, the Corporation recorded as part of interest expense unrealized losses in the valuation of interest rate swaps of approximately \$69.7 million during the first quarter of 2006.

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

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

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 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.

**Credit Risk Management**





**Table of Contents**

First BanCorp is subject to credit risk mainly with respect to its portfolio of loans receivable and off-balance sheet instruments, mainly derivatives and loan commitments. Loans receivable represents loans that First BanCorp holds for investment and, therefore, First BanCorp is at risk for the term of the loan. Loan commitments represent commitments to extend credit, subject to specific condition, for specific amounts and maturities. These commitments may expose the Corporation to credit risk and are subject to the same review and approval process as 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 and lease loss experience, current economic conditions, the fair value of the underlying collateral, and the financial condition of the borrowers, and, as such, includes amounts based on judgments and estimates made by the Corporation. Although management believes that the allowance for loan and lease losses is adequate, factors beyond the Corporation's control, including factors affecting the economies of Puerto Rico, the United States, the U.S. VI or the British VI 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 SFAS 5, *Accounting for Contingencies*.

Commercial and construction loans in amounts over \$1.0 million are individually evaluated on a quarterly basis for impairment following the provisions of SFAS 114, *Accounting by Creditors for Impairment of a Loan*. A loan is impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. The impairment loss, if any, on each individual loan identified as impaired is generally measured based on the present value of expected cash flows discounted at the loan's effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price, or the fair value of the collateral, if the loan is collateral dependent.

**Table of Contents**

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

| <i>(Dollars in thousands)</i>   | <b>Quarter ended<br/>March 31,</b> |             |
|---|------------------------------------|-------------|
|   | <b>2007</b>                        | <b>2006</b> |
| Allowance for loan and lease losses, beginning of period                  | \$ 158,296                         | \$ 147,999  |
| Provision for loan and lease losses                                       | 24,914                             | 19,376      |
| Loans charged-off:  |                                    |             |
| Residential real estate   | (165)                              | (213)       |
| Commercial and Construction   | (3,260)                            | (1,987)     |
| Finance leases  | (2,126)                            | (694)       |
| Consumer  | (17,626)                           | (13,555)    |
| Recoveries  | 1,386                              | 1,670       |
| Net charge-offs   | (21,791)                           | (14,779)    |
| Allowance for loan and lease losses, end of period                        | \$ 161,419                         | \$ 152,596  |
| Allowance for loan and lease losses to period end total loans receivable  | 1.45%                              | 1.17%       |
| Net charge-offs annualized to average loans outstanding during the period | 0.78%                              | 0.46%       |
| Provision for loan and lease losses to net charge-offs during the period  | 1.14x                              | 1.31x       |

First BanCorp's allowance for loan and lease losses was \$161.4 million at March 31, 2007, compared to \$152.6 million at March 31, 2006. The provision for loan and lease losses for the quarter ended March 31, 2007 amounted to \$24.9 million, compared to \$19.4 million for the quarter ended March 31, 2006. The increase in the provision for 2007, compared to 2006, was principally due to the growth in the Corporation's commercial (other than secured commercial loans to local financial institutions) and residential real estate portfolios coupled with increasing trends in non-performing loans and charge-offs experienced during 2007 as compared to the first quarter of 2006 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 in a midst of a recession since March 2006. The 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 utility 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.

First BanCorp's ratio of the allowance for loan and lease losses to period end total loans receivable increased by 28 basis points at March 31, 2007 compared to the ratio at March 31, 2006. The increase during 2007 mainly reflects the increase in the allowance as a result of the increasing trend in non-performing loans. The Corporation's ratio of the provision for loan and lease losses to net charge-offs for quarter ended March 31, 2007 totaled 114%, compared to 131% for the corresponding period in 2006. The decrease during the first quarter of 2007 mainly reflects an increase of net charge-offs in the commercial loan portfolio on which historically the Corporation has experienced low rates of losses and as a consequence the provision for loan losses did not increase proportionately with the increase in net charge-offs.

**Table of Contents**

*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 reversed and 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 for 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.

**Table of Contents**

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

|   | <b>March<br/>31,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|-------------------------------|----------------------------------|
|   | (Dollars in thousands)        |                                  |
| Non-accruing loans:   |                               |                                  |
| Residential real estate   | \$ 132,474                    | \$ 114,828                       |
| Commercial, commercial real estate and construction                           | 79,137                        | 82,713                           |
| Finance leases  | 6,353                         | 8,045                            |
| Consumer  | 42,014                        | 46,501                           |
|   | 259,978                       | 252,087                          |
| Other real estate owned   | 3,110                         | 2,870                            |
| Other repossessed property  | 13,899                        | 12,103                           |
| Total non-performing assets   | \$ 276,987                    | \$ 267,060                       |
| Past due loans  | \$ 33,275                     | \$ 31,645                        |
| Non-performing assets to total assets   | 1.61%                         | 1.54%                            |
| Non-accruing loans to total loans receivable                                  | 2.34%                         | 2.24%                            |
| Allowance for loan and lease losses   | \$ 161,419                    | \$ 158,296                       |
| Allowance to total non-accruing loans   | 62.09%                        | 62.79%                           |
| Allowance to total non-accruing loans excluding residential real estate loans | 126.60%                       | 115.33%                          |

As a result of the increase in delinquencies, the Corporation's non-accruing loans to total loans receivable ratio increased 10 basis points from 2.24% at December 31, 2006 to 2.34% at March 31, 2007. The increase was mainly due to increases in non-accruing loans in the residential real estate portfolio.

At March 31, 2007, the ratio of allowance for loan and lease losses to total non-accruing loans totaled 62.09%, a decrease of 70 basis points compared to the ratio at December 31, 2006. The decrease mainly reflects a higher proportion of residential real estate loans in the composition of the Corporation's total non-accruing loans. Historically, the Corporation has experienced the lowest rates of losses on 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. Excluding residential real estate loans, the ratio of the allowance for loan and lease losses to non-accruing loans increased from 115.33% at December 31, 2006 to 126.60% at March 31, 2007.

**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.

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



**Table of Contents**

Corporation's principal 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 able 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 CDs. In addition, the average life of the retail brokered CDs was approximately 6.3 years at March 31, 2007. Approximately 60% of these certificates are callable, but only at the Corporation's option.

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

Over the last three years, the Corporation has committed substantial resources to its mortgage banking subsidiary, FirstMortgage with the goal of becoming a leading institution in the highly competitive residential mortgage loans market. As a result, residential real estate loans as a percentage of total loans receivable have increased over time from 14% at December 31, 2004 to 26% at March 31, 2007. Commensurate with the increase in its mortgage banking activities, the Corporation has also invested in technology and personnel to enhance the Corporation's secondary mortgage market capabilities. The enhanced capabilities improve the Corporation's liquidity profile as it allows the Corporation to derive, if needed, liquidity from the sale of mortgage loans in the secondary market. The U.S. (including Puerto Rico) secondary mortgage market is the most liquid in the world in large part because of the sale or guarantee programs maintained by FHA, VA, HUD, FNMA and FHLMC.

**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, the 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.

**Legal and Regulatory Risk**

Legal and regulatory risk includes the risk of non-compliance with applicable legal and regulatory requirements, the risk of adverse legal judgments against the Corporation, and the risk that a counterparty's performance obligations will be unenforceable. The Corporation is subject to extensive regulation in the different jurisdictions in which it conducts its business, and this regulatory scrutiny has been significantly increasing over the last several years. The Corporation has established and continues to enhance procedures based on legal and regulatory requirements that are reasonably designed to ensure compliance with all applicable statutory and regulatory requirements. In 2006, as part of the implementation of the enterprise risk management framework, the Corporation revised and implemented a new corporate compliance function,

**Table of Contents**

headed by a newly designated Compliance Director. The Corporation's Compliance Director reports to the Chief Risk Officer and is responsible for the oversight of regulatory compliance and implementation an enterprise-wide compliance risk assessment process. Additional Compliance Officers roles were established in each major business areas with direct reporting relationships to the Corporate Compliance Group.



**Table of Contents**

**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, including its Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of First BanCorp's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of March 31, 2007. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective.

**Internal Control Over Financial Reporting**

There have not been changes in the Corporation's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

**Table of Contents**

**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 ended 2004, 2003 and 2002. For information on these proceedings, please refer to Note 16 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 2006 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.

**Table of Contents**

**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:

Date: September 24, 2007

**First BanCorp.**  
Registrant

By: /s/ Luis M. Beauchamp

Luis M. Beauchamp  
Chairman, President and Chief  
Executive Officer

Date: September 24, 2007

By: /s/ Fernando Scherrer

Fernando Scherrer  
Executive Vice President  
and Chief Financial Officer