ORIENTAL FINANCIAL GROUP INC
Form 10-Q
October 17, 2006

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

or

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

For the transition period from __________ to __________

Commission File Number 001-12647

Oriental Financial Group Inc.

Incorporated in the Commonwealth of Puerto Rico, IRS Employer Identification No. 66-0538893

Principal Executive Offices:
997 San Roberto Street
Oriental Center 10th Floor
Professional Offices Park
San Juan, Puerto Rico 00926
Telephone Number: (787) 771-6800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes o No þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

Yes o No þ

Number of shares outstanding of the registrant s common stock, as of the latest practicable date:

24,572,557 common shares ($1.00 par value per share)
outstanding as of September 30, 2006

TABLE OF CONTENTS

Table of Contents

FORWARD-LOOKING STATEMENTS

When used in this Form 10-Q or future filings by Oriental Financial Group Inc. (the Group) with the Securities and Exchange Commission (the SEC), in the Group s press releases or other public or shareholder communications, or in oral statements made with the approval of an authorized executive officer, the words or phrases would be, will allow, intends to, will likely result, are expected to, will continue, is anticipated, estimated, project, believe, expressions are intended to identify forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

The future results of the Group could be affected by subsequent events and could differ materially from those expressed in forward-looking statements. If future events and actual performance differ from the Group s assumptions, the actual results could vary significantly from the performance projected in the forward-looking statements.

The Group wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made and are based on management s current expectations, and to advise readers that various factors, including regional and national economic conditions, substantial changes in levels of market interest rates, credit and other risks of lending and investment activities, competitive, and regulatory factors, legislative changes and accounting pronouncements, could affect the Group s financial performance and could cause the Group s actual results for future periods to differ materially from those anticipated or projected. The Group does not undertake, and specifically disclaims, any obligation to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

Table of Contents

PART I FINANCIAL INFORMATION
ITEM I FINANCIAL STATEMENTS
UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
JUNE 30, 2006 AND DECEMBER 31, 2005
(In thousands, except share data)

	June 30, 2006	December 31, 2005
ASSETS		
Cash and due from banks	$ 35,237	$ 13,789
Investments:		
Time deposits with other banks	30,000	60,000
Money market investments	5,722	3,480
Short term investments	35,722	63,480
Trading securities, at fair value with amortized cost of $362 (December 31, 2005 - $144)	368	146
Investment securities available-for-sale, at fair value with amortized cost of $1,245,907 (December 31, 2005 - $1,069,649)		
Securities pledged that can be repledged	974,763	558,719
Other investment securities	225,481	488,165
Total investment securities available-for-sale	1,200,244	1,046,884
Investment securities held-to-maturity, at amortized cost with fair value of $2,158,770 (December 31, 2005 - $2,312,832)		
Securities pledged that can be repledged	1,960,268	1,917,805
Other investment securities	282,951	428,450
Total investment securities held-to-maturity	2,243,219	2,346,255
Federal Home Loan Bank (FHLB) stock, at cost	18,269	20,002
Total investments	3,497,822	3,476,767
Securities sold but not yet delivered	710	44,009
Loans:		
Mortgage loans held-for-sale, at lower of cost or market	9,564	8,946
Loans receivable, net of allowance for loan losses of $7,501 (December 31, 2005 - $6,630)	1,144,374	894,362
Total loans, net	1,153,938	903,308

Accrued interest receivable	31,313	29,067
Premises and equipment, net	17,358	14,828
Deferred tax asset, net	14,861	12,222
Foreclosed real estate	4,379	4,802
Other assets	77,044	48,157
Total assets	$ 4,832,662	$ 4,546,949
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Demand deposits	$ 141,260	$ 146,623
Savings accounts	171,034	82,641
Certificates of deposit	901,553	1,069,304
Total deposits	1,213,847	1,298,568
Borrowings:		
Federal funds purchased and other short term borrowings	17,098	4,455
Securities sold under agreements to repurchase	2,856,361	2,427,880
Advances from FHLB	285,500	313,300
Term notes	15,000	15,000
Subordinated capital notes	72,166	72,166
Total borrowings	3,246,125	2,832,801
Securities purchased but not yet received	6,539	43,354
Accrued expenses and other liabilities	25,868	30,435
Total liabilities	4,492,379	4,205,158
Commitments and Contingencies		
Stockholders equity:		
Preferred stock, $1 par value; 5,000,000 shares authorized; $25 liquidation value; 1,340,000 shares of Series A and 1,380,000 shares of Series B issued and outstanding	68,000	68,000
Common stock, $1 par value; 40,000,000 shares authorized; 25,369,875 shares issued (December 31, 2005 - 25,350,125 shares)	25,370	25,350
Additional paid-in capital	208,620	208,454
Legal surplus	37,114	35,863
Retained earnings	52,368	52,340
Treasury stock, at cost 807,713 shares (December 31, 2005 - 770,472 shares)	(10,779)	(10,332)
Accumulated other comprehensive loss, net of tax of $3,381 (December 31, 2005 - $1,810)	(40,410)	(37,884)

Total stockholders equity	340,283	341,791
Total liabilities and stockholders equity	$ 4,832,662	$ 4,546,949

See notes to unaudited consolidated financial statements.

Table of Contents

UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(In thousands, except per share data)

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2006	2005 (As Restated)	2006	2005 (As Restated)
Interest income:				
Loans	$ 18,311	$ 14,934	$ 34,564	$ 28,357
Mortgage-backed securities	23,887	22,626	48,387	47,401
Investment securities	13,973	11,037	28,473	20,335
Short term investments	723	279	1,462	355
Total interest income	56,894	48,876	112,886	96,448
Interest expense:				
Deposits	11,146	8,697	21,644	16,320
Securities sold under agreements to repurchase	31,128	17,583	57,491	33,969
Advances from FHLB, term notes and other borrowings	2,568	2,143	5,190	4,188
Subordinated capital notes	1,344	1,165	2,641	2,273
Total interest expense	46,186	29,588	86,966	56,750
Net interest income	10,708	19,288	25,920	39,698
Provision for loan losses	947	850	2,048	1,510
Net interest income after provision for loan losses	9,761	18,438	23,872	38,188
Non-interest income:				
Financial service revenues	4,066	3,249	7,317	6,419
Banking service revenues	2,511	2,064	4,687	3,893
Investment banking revenues	852	162	2,561	339
Net gain (loss) on:				
Mortgage banking activities	634	1,168	1,070	2,241
Securities available-for-sale		1,420	19	4,056
Derivatives	(23)	(1,866)	859	(4,670)
Trading securities	(8)	(42)	21	(53)
Other	(511)	282	(60)	311
Total non-interest income, net	7,521	6,437	16,474	12,536

Non-interest expenses:				
Compensation and employee benefits	5,627	4,402	11,801	7,697
Occupancy and equipment	2,793	3,066	5,682	5,532
Advertising and business promotion	1,300	1,420	2,366	2,907
Professional and service fees	1,601	1,777	3,225	3,614
Communication	395	410	843	786
Loan servicing expenses	509	430	964	831
Taxes, other than payroll and income taxes	573	471	1,173	934
Electronic banking charges	494	543	962	1,060
Printing, postage, stationery and supplies	359	207	544	416
Insurance	219	188	432	375
Other	914	979	1,675	1,888
Total non-interest expenses	14,784	13,893	29,667	26,040
Income before income taxes	2,498	10,982	10,679	24,684
Income tax expense (benefit)	(21)	377	110	(2,294)
Net income	2,519	10,605	10,569	26,978
Less: Dividends on preferred stock	(1,201)	(1,202)	(2,401)	(2,401)
Income available to common shareholders	$ 1,318	$ 9,403	$ 8,168	$ 24,577
Income per common share:				
Basic	$ 0.05	$ 0.38	$ 0.33	$ 1.00
Diluted	$ 0.05	$ 0.37	$ 0.33	$ 0.96
Average common shares outstanding	24,599	24,847	24,608	24,571
Average potential common shares-options	106	601	128	1,104
	24,705	25,448	24,736	25,675
Cash dividends per share of common stock	$ 0.14	$ 0.14	$ 0.28	$ 0.28

See notes to unaudited consolidated financial statements.

Table of Contents

UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(In thousands)

	Six-Month Period Ended June 30,	
CHANGES IN STOCKHOLDERS EQUITY:	**2006**	**2005 (As Restated)**
Preferred stock:		
Balance at beginning and end of period	$ 68,000	$ 68,000
Common stock:		
Balance at beginning of period	25,350	24,601
Stock options exercised	20	503
Balance at end of period	25,370	25,104
Additional paid-in capital:		
Balance at beginning of period as previously reported		186,405
Prior period adjustment		13,241
Balance at beginning of period as restated	208,454	199,646
Stock-based compensation expense	16	6,261
Stock options exercised	150	905
Common stock issuance cost		(8)
Balance at end of period	208,620	206,804
Legal surplus:		
Balance at beginning of period	35,863	31,280
Transfer from retained earnings	1,251	2,613
Balance at end of period	37,114	33,893
Retained earnings:		
Balance at beginning of period as previously reported		59,884
Prior period adjustment		(28,203)
Balance at beginning of period as restated	52,340	31,681
Net income	10,569	26,978
Cash dividends declared on common stock	(6,889)	(6,940)
Cash dividends declared on preferred stock	(2,401)	(2,401)

Transfer to legal surplus	(1,251)	(2,613)
Balance at end of period	52,368	46,705
Treasury stock:		
Balance at beginning of period	(10,332)	(91)
Stock used to match defined contribution plan 1165(e)	135	235
Stock purchased	(582)	(3,512)
Balance at end of period	(10,779)	(3,368)
Accumulated other comprehensive income (loss), net of tax:		
Balance at beginning of period	(37,884)	(37,023)
Other comprehensive income (loss), net of tax	(2,526)	(1,360)
Balance at end of period	(40,410)	(38,383)
Total stockholders equity	$ 340,283	$ 338,755

UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(In thousands)

COMPREHENSIVE INCOME	Quarter Ended June 30, 2006	Quarter Ended June 30, 2005 (As Restated)	Six-Month Period Ended June 30, 2006	Six-Month Period Ended June 30, 2005 (As Restated)
Net income	$ 2,519	$ 10,605	$ 10,569	$ 26,978
Other comprehensive income (loss):				
Unrealized (loss) gain on securities available-for-sale arising during the period	(9,788)	6,717	(21,351)	(8,991)
Realized (gain) loss on investment securities available-for-sale included in net income	(19)	832	(19)	(1,804)
Unrealized gain (loss) on derivatives designated as cash flows hedges arising during the period	8,106	(6,565)	18,022	7,018
Realized loss (gain) on derivatives designated as cash flow hedges included in net income		820	(749)	2,743
Income tax effect related to unrealized loss on securities available-for-sale	992	(405)	1,571	(326)
Other comprehensive (loss) income for the period, net of tax	(709)	1,399	(2,526)	(1,360)

Comprehensive income	$ 1,810	$ 12,004	$ 8,043	$ 25,618

See notes to unaudited consolidated financial statements.

Table of Contents

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(In thousands)

	Six-Month Period Ended June 30, 2006	2005 (As Restated)
Cash flows from operating activities:		
Net income	$ 10,569	$ 26,978
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of deferred loan origination fees, net of costs	(760)	(982)
Amortization of premiums, net of accretion of discounts on investment securities	1,045	4,987
Depreciation and amortization of premises and equipment	2,672	3,143
Deferred income tax expense (benefit)	(1,068)	205
Equity in losses (earnings) of investment in limited liability partnership	271	(247)
Provision for loan losses	2,048	1,510
Stock-based compensation (benefit)	16	(6,287)
Loss (gain) on:		
Sale of securities available-for-sale	(19)	(4,056)
Mortgage banking activities	(1,070)	(2,241)
Derivatives	(859)	4,670
Sale of foreclosed real estate	(115)	
Sale of premises and equipment	(8)	
Originations of loans held-for-sale	(33,830)	(107,035)
Proceeds from sale of loans held-for-sale	13,525	28,893
Net decrease (increase) in:		
Trading securities	(222)	850
Accrued interest receivable	(2,246)	(2,446)
Other assets	(7,375)	(10,454)
Net increase (decrease) in:		
Accrued interest on deposits and borrowings	(2,492)	3,329
Other liabilities	(2,030)	7,351
Net cash used in operating activities	(21,948)	(51,832)
Cash flows from investing activities:		
Net decrease (increase) in time deposits with other banks	30,000	(30,000)
Purchases of:		
Investment securities available-for-sale	(278,566)	(623,529)
Investment securities held-to-maturity	(6,500)	(236,399)
Equity options and put options		(739)
FHLB stock	(9,733)	
Maturities and redemptions of:		
Investment securities available-for-sale	73,173	400,720
Investment securities held-to-maturity	108,975	100,340

FHLB stock		11,466		1,102
Proceeds from sales of:				
Investment securities available-for-sale		57,130		449,622
Foreclosed real estate		2,142		2,149
Premises and equipment				3,355
Loan production:				
Origination and purchase of loans, excluding loans held-for-sale		(321,068)		(164,269)
Principal repayment of loans		68,474		108,314
Additions to premises and equipment		(5,194)		(2,340)
Net cash provided by (used in) investing activities		(269,701)		8,326
Cash flows from financing activities:				
Net increase (decrease) in:				
Deposits		(85,449)		178,064
Securities sold under agreements to repurchase		425,516		(146,070)
Federal funds purchased and other short term borrowings		12,643		12,310
Proceeds from:				
Advances from FHLB		1,322,995		917,570
Exercise of stock options, net		170		1,408
Repayments of advances from FHLB		(1,350,795)		(917,570)
Common stocks used to match defined contribution plan 1165(e)		135		(3,157)
Repurchase of treasury stocks		(582)		
Dividends paid		(9,294)		(9,321)
Net cash provided by financing activities		315,339		33,234
Net change in cash and cash equivalents		23,690		(10,272)
Cash and cash equivalents at beginning of period		17,269		34,955
Cash and cash equivalents at end of period	$	40,959	$	24,683
Cash and cash equivalents include:				
Cash and due from banks	$	35,237	$	14,892
Money market investments		5,722		9,791
	$	40,959	$	24,683
Supplemental Cash Flow Disclosure and Schedule of Noncash Activities:				
Interest paid	$	90,826	$	53,421
Income taxes paid	$		$	554
Mortgage loans securitized into mortgage-backed securities	$	20,447	$	33,662
Accrued dividend payable	$	3,441	$	3,487
Other comprehensive loss for the period	$	2,526	$	1,360

Securities sold but not yet delivered	$	710	$	1,034
Securities and loans purchased but not yet received	$	6,539	$	22,772
Transfer from loans to foreclosed real estate	$	1,604	$	1,937

See notes to unaudited consolidated financial statements.

ORIENTAL FINANCIAL GROUP INC.
Notes to Unaudited Consolidated Financial Statements
NOTE 1 BASIS OF PRESENTATION:

The accounting and reporting policies of Oriental Financial Group Inc. (the Group or Oriental) conform with U.S. generally accepted accounting principles (GAAP) and to financial services industry practices.

The unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of management, these consolidated financial statements include all adjustments necessary, all of which are of normal recurring nature, to present fairly the consolidated financial condition as of June 30, 2006 and December 31, 2005, and the results of operations, and the cash flows for the six-month periods ended June 30, 2006 and 2005. All significant intercompany balances and transactions have been eliminated in the accompanying unaudited consolidated financial statements. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such SEC rules and regulations. Management believes that the disclosures made are adequate to make the information presented not misleading. Financial information as of December 31, 2005 has been derived from the Group s audited consolidated financial statements. The results of operations and cash flows for the six-month periods ended June 30, 2006 and 2005 are not necessarily indicative of the results to be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto for the transition period ended December 31, 2005, included in the Group s Form 10-K.

Nature of Operations

Oriental is a diversified, publicly-owned financial holding company incorporated under the laws of the Commonwealth of Puerto Rico. It has four direct subsidiaries, Oriental Bank and Trust (the Bank), Oriental Financial Services Corp. (Oriental Financial Services), Oriental Insurance, Inc. (Oriental Insurance), and Caribbean Pension Consultants, Inc., which is located in Boca Raton, Florida. The Group also has two special purpose entities, Oriental Financial (PR) Statutory Trust I (the Statutory Trust I) and Oriental Financial (PR) Statutory Trust II (the Statutory Trust II). Through these subsidiaries and its divisions, the Group provides a wide range of financial services such as mortgage, commercial and consumer lending, financial planning, insurance sales, money management and investment banking and brokerage services, as well as corporate and individual trust services. Note 9 to the unaudited consolidated financial statements present further information about the operations of the Group s business segments.

The main offices of the Group and its subsidiaries are located in San Juan, Puerto Rico. The Group is subject to examination, regulation and periodic reporting under the U.S. Bank Holding Company Act of 1956, as amended, which is administered by the Board of Governors of the Federal Reserve System.

The Bank operates through twenty-four branches located throughout Puerto Rico and is subject to the supervision, examination and regulation of the Office of the Commissioner of Financial Institutions of Puerto Rico and the Federal Deposit Insurance Corporation (FDIC). The Bank offers banking services such as commercial and consumer lending, saving and time deposit products, financial planning, and corporate and individual trust services, and capitalizes on its commercial banking network to provide mortgage lending products to its clients. The Bank also operates two international banking entities (IBEs) pursuant to the International Banking Center Regulatory Act of Puerto Rico, as amended (the IBE Act): O.B.T. International Bank, which is a unit of the Bank, and Oriental International Bank Inc., which is a wholly-owned subsidiary of the Bank. On January 1, 2004, the Group transferred most of the assets and liabilities of O.B.T. International Bank to Oriental International Bank Inc. The IBE offers the Bank certain Puerto Rico tax advantages and its services are limited under Puerto Rico law to persons and assets/liabilities located outside of Puerto Rico.

Oriental Financial Services is subject to the supervision, examination and regulation of the National Association of Securities Dealers, Inc., the SEC, and the Office of the Commissioner of Financial Institutions of Puerto Rico.

Oriental Insurance is subject to the supervision, examination and regulation of the Office of the Commissioner of Insurance of Puerto Rico.

Change of Fiscal Year

On August 30, 2005, the Group s Board of Directors (the Board) approved an amendment to Section 1 of Article IX of the Group s By-Laws to change its fiscal year to a calendar year. The Group s fiscal year was from July 1 of each year to June 30 of the following year. The Group s transition period was from July 1, 2005 to December 31, 2005.

Significant Accounting Policies

The unaudited consolidated financial statements of the Group are prepared in accordance with GAAP and with the general practices within the financial services industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Group believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity.

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses based on losses that are estimated to occur. Loan losses are charged against the allowance when the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The Group follows a systematic methodology to establish and evaluate the adequacy of the allowance for loan losses. This methodology consists of several key elements. The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

Larger commercial loans that exhibit potential or observed credit weaknesses are subject to individual review and grading. Where appropriate, allowances are allocated to individual loans based on management s estimate of the borrower s ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Group.

Included in the review of individual loans are those that are impaired, as provided in the Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan. A loan is considered impaired when, based on current information and events, it is probable that the Group will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral, if the loan is collateral dependent. Loans are individually evaluated for impairment, except large groups of small balance homogeneous loans that are collectively evaluated for impairment and loans that are recorded at fair value or at the lower of cost or market. The Group measures for impairment all commercial loans over $250,000. The portfolios of mortgage and consumer loans are considered homogeneous, and are evaluated collectively for impairment.

For loans that are not individually graded, the Group uses a methodology that follows a loan credit risk rating process that involves dividing loans into risk categories. The following are the credit risk categories: pass, special mention, substandard, doubtful and loss.

The Group, using an aged-based rating system, applies an overall allowance percentage to each loan portfolio category based on historical credit losses adjusted for current conditions and trends. This delinquency-based calculation is the starting point for management s determination of the required level of the allowance for loan losses. Other data considered in this determination includes: the overall historical loss trends and other information including underwriting standards and economic trends.

Loan loss ratios and credit risk categories are updated quarterly and are applied in the context of GAAP and the importance of depository institutions having prudent, conservative, but not excessive loan allowances that fall within an acceptable range of estimated losses. While management uses available information in estimating possible loan losses, future changes to the allowance may be necessary based on factors beyond the Group s control, such as factors affecting general economic conditions.

Financial Instruments

Certain financial instruments including derivatives, hedged items, trading securities and investment securities available-for-sale are recorded at fair value and unrealized gains and losses are recorded in other comprehensive income or other gains and losses as appropriate. Fair values are based on listed market prices, if available. If listed market prices are not available, fair value is determined based on other relevant factors, including price quotations for similar instruments. The fair values of certain derivative contracts are derived from pricing models that consider current market and contractual prices for the underlying financial instruments as well as time value and yield curve or volatility factors underlying the positions.

Impairment of Investment Securities

The Group evaluates its securities available-for-sale and held-to-maturity for impairment. An impairment charge in the consolidated statements of income is recognized when the decline in the fair value of investments below their cost basis is judged to be other-than-temporary. The Group considers various factors in determining whether it should recognize an impairment charge, including, but not limited to the length of time and extent to which the fair value has been less than its cost basis, and the Group s ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. For debt securities, the Group also considers, among other factors, the investors repayment ability on its debt obligations and its cash and capital generation ability.

Income Taxes

In preparing the consolidated financial statements, the Group is required to estimate income taxes. This involves an estimate of current income tax expense together with an assessment of temporary differences resulting from differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The determination of current income tax expense involves estimates and assumptions that require the Group to assume certain positions based on its interpretation of current tax laws and regulations. Changes in assumptions affecting estimates may be required in the future and estimated tax assets or liabilities may need to be increased or decreased accordingly. The accrual for tax contingencies is adjusted in light of changing facts and circumstances, such as the progress of tax audits, case law and emerging legislation. The Group s effective tax rate includes the impact of tax contingency accruals and changes to such accruals, including related interest and surcharges, as considered appropriate by management. When particular matters arise, a number of years may elapse before such matters are audited and finally resolved. Favorable resolution of such matters could be recognized as a reduction to the Group s effective rate in the year of resolution. Unfavorable settlement of any particular issue could increase the effective rate and may require the use of cash in the year of resolution.

The Group maintained an effective tax rate lower than the maximum marginal statutory rate of 43.5% as of June 30, 2006, mainly due to the interest income arising from investments exempt from Puerto Rico income taxes, net of expenses attributable to the exempt income. Exempt interest relates mostly to interest earned on obligations of the United States and Puerto Rico governments and certain mortgage-backed securities, including securities held by the Bank s international banking entities.

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of the Group s net deferred tax assets assumes that the Group will be able to generate sufficient future taxable income based on estimates and assumptions. If these estimates and related assumptions change in the future, the Group may be required to record valuation allowances against its deferred tax assets resulting in additional income tax expense in the consolidated statements of income. Management evaluates the realizability of the deferred tax assets on a regular basis and assesses the need for a valuation allowance. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Group s tax provision in the period of change. As of June 30, 2006, a valuation allowance of approximately $2.0 million was recorded to offset deferred tax assets from loss carry forwards that the Group considers it will not be realized in future periods.

Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the projections of future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Group will realize the benefits of these deductible differences, net of the existing valuation allowances at June 30, 2006. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carry forward period are reduced.

On August 1, 2005 the Puerto Rico Legislature approved Act No. 41 that imposes an additional tax of 2.5% on taxable income exceeding $20,000. The law is effective for tax years beginning after December 31, 2004 and ending on or before December 31, 2006. This additional tax imposition did not have a material effect on the Group s consolidated operational results for the six-month period ended June 30, 2006 due to the tax exempt composition of the Group s investments.

On May 13, 2006, the Puerto Rico Governor signed into law Act No. 89 to (i) increase the recapture tax that is imposed on corporations and partnerships generating taxable income in excess of $500,000 with the purpose of increasing the maximum marginal corporate income tax rate for these entities from 39% to 41.5%, and (ii) to impose an additional tax of 2% on the taxable income of banking corporations covered under the Puerto Rico the Group s investments.

On May 16, 2006, the Puerto Rico Governor also signed into law Act No. 98 to impose a one-time 5% extraordinary tax that is imposed on an amount equal to the net taxable income of non-exempt corporations and partnerships for the last taxable year ended on or before December 31, 2005. On July 31, 2006 Act No. 137 was signed into law to amend various provisions of Act No. 98. The payment of this extraordinary tax constitutes, in effect, a prepayment, as the taxpayer will be allowed to credit the amount so paid against its Puerto Rico income tax liability for taxable years beginning after July 31, 2006 provided the credit claimed in any taxable year does not exceed 25% of the extraordinary tax paid. Since no member of the Group generated taxable income for the year 2005, this additional tax imposition will not apply and, therefore, it will not affect on the Group s consolidated operational results.

Stock Option Plans

At June 30, 2006, the Group had three stock-based employee compensation plans: the 1996, 1998, and 2000 Incentive Stock Option Plans. These plans offer key officers, directors and employees an opportunity to purchase shares of the Group s common stock. The Compensation Committee of the Board of Directors has sole authority and absolute discretion as to the number of stock options to be granted to any officer, director or employee, their vesting rights, and the options exercise prices. The plans provide for a proportionate adjustment in the exercise price and the number of shares that can be purchased in case of merger, consolidation, combination, exchange of shares, other reorganization, recapitalization, reclassification, stock dividend, stock split or reverse stock split in which the number of shares of common stock of the Group as a whole are increased, decreased, changed into or exchanged for a different number or kind of shares or securities. Stock options vest upon completion of specified years of service.

Up to June 30, 2005, the Group accounted for its stock compensation award plans under the recognition and measurement principles of the Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations. Compensation expense for option awards with traditional terms was generally recognized for any excess of the quoted market price of the Group s stock at measurement date over the amount an employee must pay to acquire the stock. No stock-based employee compensation cost was reflected for the awards with traditional terms as the options had an exercise price equal to the market value of the underlying common stock on the date of grant. The Financial Accounting Standards Board (FASB) Interpretation No. 28 Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28) an interpretation of APB 25 clarifies aspects of accounting for compensation related to stock appreciation rights and other variable stock option or award plans. With regards to stock option awards with anti-dilution provisions, where the terms are such that the number of shares that the employee is entitled to receive and the purchase price depends on events occurring after the date of the grant, compensation is measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise s stock covered by a grant exceeds the option price and is accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value are reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur.

On June 30, 2005, the Compensation Committee of the Group s Board of Directors approved the acceleration of the vesting of all outstanding options to purchase shares of common stock of the Group that were held by employees, officers and directors as of that date. As a result, options to purchase 1,219,333 shares became exercisable. The purpose of the accelerated vesting was to enable the Group to avoid recognizing in its income statement compensation expense associated with these options in future periods, upon adoption of FASB Statement No. 123(R).

Effective July 1, 2005, the Group adopted SFAS No. 123R Share-Based Payment (SFAS 123R), an amendment of SFAS 123 Accounting for Stock-Based Compensation using the modified prospective transition method. SFAS 123R requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award with the cost to be recognized over the service period. SFAS 123R is effective for financial statements as of the beginning of the first interim or annual reporting period of the first fiscal year that began after June 15, 2005. SFAS No. 123R applies to all awards unvested and granted after this effective date and awards modified, repurchased, or cancelled after that date.

The Group recorded approximately $16,000 during the six-month period ended June 30, 2006 related to compensation expense for options issued subsequent to the adoption of SFAS 123R. The remaining unrecognized compensation cost related to unvested awards as of June 30, 2006, was approximately $249,000 and the weighted average period of time over which this cost will be recognized is approximately 7 years.

Had the estimated fair value of the options granted been included in compensation expense for the period indicated below, the Group s net earnings and earnings per share would have been as follows:

Table of Contents

(In thousands, except for per share data)		Quarter Ended June 30, 2005		Six-month Period Ended June 30, 2005
Net income, as reported	$	10,605	$	26,978
Deduct: Shared-based compensation reduction included in reported earnings		(2,964)		(6,287)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards		(303)		(716)
Pro forma net income		7,338		19,975
Less: Dividends on preferred stock		(1,202)		(2,401)
Pro forma income available to common shareholders	$	6,136	$	17,574
Earnings per share:				
Basic as reported	$	0.38	$	1.00
Basic pro forma	$	0.25	$	0.72
Diluted as reported	$	0.37	$	0.96
Diluted pro forma	$	0.24	$	0.68
Average common shares outstanding		24,847		24,571
Average potential common share-options		601		1,104
		25,448		25,675

The average fair value of each option granted during the six-month period ended June 30, 2006 and 2005 was $4.05 and $15.32, respectively. The average fair value of each option granted was estimated at the date of the grant using the Black-Scholes option pricing model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no restrictions and are fully transferable and negotiable in a free trading market. Black-Scholes does not consider the employment, transfer or vesting restrictions that are inherent in the Group s employee options. Use of an option valuation model, as required by GAAP, includes highly subjective assumptions based on long-term predictions, including the expected stock price volatility and average life of each option grant. The following assumptions were used in estimating the fair value of the options granted:

	Six-month period ended June 30, 2006	Six-month period ended June 30, 2005
Weighted Average Assumptions:		
Dividend yield	3.87%	3.71%
Expected volatility	34.26%	42.33%

Risk-free interest rate	4.19%	3.92%
Expected life (in years)	8.5	7

The expected term of share options granted represents the period of time that share options granted are expected to be outstanding. Expected volatilities are based on historical volatility of the Group s shares over the most recent period equal to the expected term of the share option.

Table of Contents

NOTE 2 INVESTMENT SECURITIES:

The amortized cost, gross unrealized gains and losses, fair value, and weighted average yield of the investment securities as of June 30, 2006 and December 31, 2005, were as follows:

	June 30, 2006 (In thousands)				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Available-for-sale					
US Treasury securities	$ 199,746	$	$ 9,144	$ 190,602	3.64%
Puerto Rico Government and agency obligations	28,396	76	1,355	27,117	5.59%
Corporate bonds and other	112,383		3,112	109,271	4.51%
Total investment securities	**340,525**	**76**	**13,611**	**326,990**	
FNMA and FHLMC certificates	567,958		22,054	545,904	4.71%
GNMA certificates	48,587	281	543	48,325	5.58%
Collateralized mortgage obligations (CMO s)	288,837	6	9,818	279,025	5.11%
Total mortgage-backed-securities and CMO s	**905,382**	**287**	**32,415**	**873,254**	
Total securities available-for-sale	**$ 1,245,907**	**$ 363**	**$ 46,026**	**$ 1,200,244**	**4.67%**
Held-to-maturity					
US Treasury securities	40,059		375	39,684	2.52%
Obligations of U.S. government sponsored entities	1,028,246		37,261	990,985	3.74%
Puerto Rico Government and agency obligations	55,284		5,886	49,398	5.29%
Total investment securities	**1,123,589**		**43,522**	**1,080,067**	
FNMA and FHLMC certificates	763,141		29,956	733,185	5.03%
GNMA certificates	198,057		6,690	191,367	5.33%
Collateralized mortgage obligations	158,432		4,281	154,151	5.13%
Total mortgage-backed-securities and CMO s	**1,119,630**		**40,927**	**1,078,703**	

Total securities held-to-maturity	**2,243,219**		**84,449**	**2,158,770**	**5.03%**
Total	**$ 3,489,126**	**$ 363**	**$ 130,475**	**$ 3,359,014**	**4.85%**

Table of Contents

	December 31, 2005 (In thousands)				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Available-for-sale					
US Treasury securities	$ 174,836	$	$ 5,599	$ 169,237	3.45%
Puerto Rico Government and agency obligations	28,356	183	340	28,199	5.29%
Corporate bonds and other	92,005		1,468	90,537	4.75%
Total investment securities	**295,197**	**183**	**7,407**	**287,973**	
FNMA and FHLMC certificates	488,356		12,193	476,163	5.17%
GNMA certificates	36,799	630	129	37,300	5.83%
Collateralized mortgage obligations (CMO s)	249,297	552	4,401	245,448	5.47%
Total mortgage-backed-securities and CMO s	**774,452**	**1,182**	**16,723**	**758,911**	
Total securities available-for-sale	**1,069,649**	**1,365**	**24,130**	**1,046,884**	**4.95%**
Held-to-maturity					
US Treasury securities	60,168		818	59,350	2.84%
Obligations of US Government sponsored agencies	1,021,634	77	19,661	1,002,050	4.09%
Puerto Rico Government and agency obligations	62,084		2,987	59,097	5.32%
Total investment securities	**1,143,886**	**77**	**23,466**	**1,120,497**	
FNMA and FHLMC certificates	822,870	1,238	10,389	813,719	5.05%
GNMA certificates	216,237	1,371	1,196	216,412	5.52%
Collateralized mortgage obligations	163,262	129	1,187	162,204	5.42%
Total mortgage-backed-securities and CMO s	**1,202,369**	**2,738**	**12,772**	**1,192,335**	
Total securities held-to-maturity	**2,346,255**	**2,815**	**36,238**	**2,312,832**	**4.65%**
Total	**$ 3,415,904**	**$ 4,180**	**$ 60,368**	**$ 3,359,716**	**4.75%**

The amortized cost and fair value of the Group s investment securities available-for-sale and held-to-maturity at June 30, 2006, by contractual maturity, are shown in the next table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(In thousands)			
	Available-for-sale		Held-to-maturity	
	Amortized Cost	**Fair Value**	**Amortized Cost**	**Fair Value**
Investment securities				
Due within one year	$ 5,000	$ 4,975	$ 274,860	$ 272,055
Due after 1 to 5 years	295,202	283,026	412,359	398,674
Due after 5 to 10 years	1,890	1,835	281,241	264,817
Due after 10 years	38,433	37,154	155,129	144,521
	340,525	**326,990**	**1,123,589**	**1,080,067**
Mortgage-backed securities				
Due within one year	228	228		
Due after 1 to 5 years	10,242	10,262		
Due after 5 to 10 years	3,327	3,163		
Due after 10 years	891,585	859,601	1,119,630	1,078,703
	905,382	**873,254**	**1,119,630**	**1,078,703**
	$1,245,907	**$1,200,244**	**$2,243,219**	**$2,158,770**

Proceeds from the sale of investment securities available-for-sale during the six-month period ended June 30, 2006 totaled approximately $57,130,000 (2005 approximately $449,622,000). Gross realized gains on those sales during the six-month period ended June 30, 2006 were approximately $19,000 (2005 gains of approximately $4.6 million and losses of approximately $500,000).

The following table shows the Group s gross unrealized losses and fair value of investment securities available-for-sale and held-to-maturity, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2006.

Available-for-sale

(In thousands)

	Less than 12 months		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
US Treasury securities	$ 24,895	$ (131)	$ 24,764
Puerto Rico Government and agency obligations	18,696	(853)	17,843
Corporate bonds and other	92,135	(3,040)	89,095
Mortgage-backed securities and CMO s	364,510	(5,695)	358,815
	500,236	**(9,719)**	**490,517**

	12 months or more		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
US Treasury securities	174,852	(9,013)	165,839
Puerto Rico Government and agency obligations	4,207	(502)	3,705
Corporate bonds and other	91	(72)	19
Mortgage-backed securities and CMO s	524,814	(26,720)	498,094
	703,964	**(36,307)**	**667,657**

	Total		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
US Treasury securities	199,747	(9,144)	190,603
Puerto Rico Government and agency obligations	22,903	(1,355)	21,548
Corporate bonds and other	92,226	(3,112)	89,114
Mortgage-backed securities and CMO s	889,324	(32,415)	856,909
	$1,204,200	**$(46,026)**	**$1,158,174**

Held-to-maturity

(In thousands)

	Less than 12 months		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
US Treasury securities	$ 331,086	$(12,441)	$ 318,645
Puerto Rico Government and agency obligations	9,966	(791)	9,175
Mortgage-backed securities and CMO s	774,431	(23,321)	751,110
	1,115,483	**(36,553)**	**1,078,930**

	12 months or more		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
US Treasury securities	737,219	(25,195)	712,024
Puerto Rico Government and agency obligations	45,318	(5,095)	40,223
Mortgage-backed securities and CMO s	345,199	(17,606)	327,593
	1,127,736	**(47,896)**	**1,079,840**

	Total		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
US Treasury securities	1,068,305	(37,636)	1,030,669
Puerto Rico Government and agency obligations	55,284	(5,886)	49,398
Mortgage-backed securities and CMO s	1,119,630	(40,927)	1,078,703
	$2,243,219	**$(84,449)**	**$2,158,770**

Securities in an unrealized loss position at June 30, 2006 are mainly composed of securities issued or backed by U.S. government agencies. The vast majority of them are rated the equivalent of AAA by nationally recognized rating organizations. The investment portfolio is structured primarily with highly liquid securities, which have a large and efficient secondary market. Valuations are performed on a monthly basis using a third party provider and dealer quotes. Management believes that the unrealized losses in the investment portfolio at June 30, 2006 are mainly related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuers. The Group is a well capitalized financial institution, which has the ability to hold the investment securities with unrealized losses until maturity or until the unrealized losses are recovered, and expects to continue its pattern of holding the securities until the forecasted recovery of fair value.

NOTE 3 LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES:

Loans Receivable

The Group s credit activities are mainly with customers located in Puerto Rico. The Group s loan transactions are encompassed within three main categories: mortgage, commercial and consumer. The composition of the Group s loan portfolio at June 30, 2006, and December 31, 2005, was as follows:

	(In thousands)	
	June 30, 2006	December 31, 2005
Residential mortgage loans	$ 848,473	$ 599,163
Home equity loans and secured personal loans	39,147	41,034
Commercial loans, mainly secured by real estate	228,008	228,163
Consumer	39,074	35,482
Loans receivable, gross	1,154,702	903,842
Less: deferred loan fees, net	(2,827)	(2,850)
Loans receivable	1,151,875	900,992
Allowance for loan losses	(7,501)	(6,630)
Loans receivable, net	1,144,374	894,362
Mortgage loans held-for-sale	9,564	8,946
Total loans, net	**$ 1,153,938**	**$ 903,308**

Allowance for Loan Losses

The Group maintains an allowance for loan losses at a level that management considers adequate to provide for probable losses based upon an evaluation of known and inherent risks. The Group s allowance for loan losses policy provides for a detailed quarterly analysis of probable losses. The analysis includes a review of historical loan loss experience, value of underlying collateral, current economic conditions, financial condition of borrowers and other pertinent factors.

While management uses available information in estimating probable loan losses, future additions to the allowance may be required based on factors beyond the Group s control. Refer to Table 4 of the Management s Discussion and Analysis of Financial Condition and Results of Operations for the changes in the allowance for loan losses for the quarters and six-month periods ended June 30, 2006 and December 31, 2005.

The Group evaluates all loans, some individually and other as homogeneous groups, for purposes of determining impairment. At June 30, 2006 and December 31, 2005, the total investment in impaired loans was $1.8 million and $3.6 million, respectively. The impaired loans were measured based on the fair value of collateral. The Group determined that no specific impairment allowance was required for such loans.

Table of Contents

NOTE 4 PLEDGED ASSETS

At June 30, 2006, residential mortgage loans amounting to $349,712,000 and investment securities with fair values amounting to $15,663,000 were pledged to secure advances and borrowings from the FHLB. Investment securities with fair values totaling $2,902,985,000, $135,282,000 and $15,860,000 at June 30, 2006, were pledged to secure securities sold under agreements to repurchase, public fund deposits, and term notes, respectively. Also, investment securities with fair value totaling $803,000 at June 30, 2006, were pledged to the Puerto Rico Treasury Department. As of June 30, 2006, investment securities available-for-sale and held-to-maturity not pledged amounted to $143,215,000 and $71,435,000 respectively. As of June 30, 2006, mortgage loans not pledged amounted to $547,471,000.

NOTE 5 OTHER ASSETS

Other assets at June 30, 2006 and December 31, 2005 include the following:

	(In thousands)	
	June 30, 2006	December 31, 2005
Investment in equity options	$ 25,999	$ 22,054
Derivative asset	20,347	2,509
Deferred charges	2,814	3,213
Prepaid expenses	2,763	2,698
Investment in Statutory Trusts	2,169	2,169
Goodwill	2,006	2,006
Investment in limited partnership	10,814	11,085
Accounts receivable and other assets, net	10,132	2,423
	$ 77,044	**$ 48,157**

NOTE 6 SUBORDINATED CAPITAL NOTES

Subordinated capital notes amounted to $72,166,000 at June 30, 2006 and December 31, 2005.

In October 2001 and August 2003, the Statutory Trust I and the Statutory Trust II, respectively, special purpose entities of the Group, were formed for the purpose of issuing trust redeemable preferred securities. In December 2001 and September 2003, $35.0 million of trust redeemable preferred securities were issued each by the Statutory Trust I and the Statutory Trust II, as part of pooled underwriting transactions. Pooled underwriting involves participating with other bank holding companies in issuing the securities through a special purpose pooling vehicle created by the underwriters.

The proceeds from these issuances were used by the Statutory Trust I and the Statutory Trust II to purchase a like amount of floating rate junior subordinated deferrable interest debentures (subordinated capital notes) issued by the Group. The first of these subordinated capital notes has a par value of $36.1 million, bears interest based on 3 month LIBOR plus 360 basis points (9.00% at June 30, 2006; 8.10% at December 31, 2005), provided, however, that prior to December 18, 2006, this interest rate shall not exceed 12.5%, payable quarterly, and matures on December 23, 2031. The second one, has a par value of $36.1 million, bears interest based on 3 month LIBOR plus 295 basis points (8.35% at June 30, 2006; December 31, 2005 7.45%), payable quarterly, and matures on September 17, 2033. Both subordinated capital notes may be called at par after five years (Statutory Trust I December 2006; Statutory Trust II September 2008). The trust redeemable preferred securities have the same maturity and call provisions as the subordinated capital notes. The subordinated deferrable interest debentures issued by the Group are accounted for as a liability denominated as subordinated capital notes on the unaudited consolidated statements of financial condition.

The subordinated capital notes are treated as Tier 1 capital for regulatory purposes. On March 4, 2005, the Federal Reserve Board issued a final rule that continues to allow trust preferred securities to be included in Tier I regulatory capital, subject to stricter quantitative and qualitative limits. Under this rule, restricted core capital elements, which are qualifying trust preferred securities, qualifying cumulative perpetual preferred stock (and related surplus) and certain minority interests in consolidated subsidiaries, are limited in the aggregate to no more than 25% of a bank holding company s core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability.

NOTE 7 OTHER BORROWINGS

At June 30, 2006, securities underlying agreements to repurchase were delivered to, and are being held by, the counterparties with whom the repurchase agreements were transacted. The counterparties have agreed to resell to the Group the same or similar securities at the maturity of the agreements.

Securities sold under agreements to repurchase at June 30, 2006 mature as follows:

	(In thousands) Balance
Due within 30 days	$ 1,391,111
Due after 30 to 90 days	1,365,109
Due after 90 to 120 days	100,141
	$ 2,856,361

At June 30, 2006, the contractual maturities of advances from the FHLB and term notes by year are as follows:

	(In thousands)	
June 30,	**Advances from FHLB**	**Term Notes**
2007	$ 210,500	$
2008	25,000	15,000
2009	50,000	
	$ 285,500	**$ 15,000**

NOTE 8 DERIVATIVES ACTIVITIES

The Group utilizes various derivative instruments for hedging purposes as part of its asset and liability management. These transactions involve both credit and market risks. The notional amounts are amounts on which calculations, payments, and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received or paid, if any. The actual risk of loss is the cost of replacing, at market, these contracts in the event of default by the counterparties. The Group controls the credit risk of its derivative financial instrument agreements through credit approvals, limits, monitoring procedures and collateral, when considered necessary.

The Group generally uses interest rate swaps and options in managing its interest rate risk exposure. Certain swaps were entered into to convert the forecasted rollover of short-term borrowings into fixed rate liabilities for longer periods and provide protection against increases in short-term interest rates. Under these swaps, the Group pays a fixed monthly or quarterly cost and receives a floating thirty or ninety-day payment based on LIBOR. Floating rate payments received from the swap counterparties partially offset the interest payments to be made on the forecasted rollover of short-term borrowings.

In August 2004, the Group entered into a $35.0 million notional amount interest rate swap to fix the cost of the subordinated capital notes of the Statutory Trust I. This swap was fixed at a rate of 2.98% and matures on December 18, 2006.

The Group s swaps, including those not designated as a hedge, and their maturity terms at June 30, 2006 and December 31, 2005 are set forth in the table below:

	(Dollars in thousands)	
	June 30, 2006	**December 31, 2005**
Swaps:		
Pay fixed swaps notional amount	$ 1,350,000	$ 1,275,000

Weighted average pay rate fixed	4.48%	3.90%
Weighted average receive rate floating	5.24%	4.39%
Maturity in months	3 to 54	1 to 60
Floating rate as a percent of LIBOR	100%	100%

The Group offers its customers certificates of deposit with an option tied to the performance of the Standard & Poor s 500 stock market index. At the end of five years depositors receive a return equal to the greater of 15% of the principal in the account or 125% of the average increase in the month-end value of the index. The Group uses option agreements with major broker-dealer companies to manage its exposure to changes in this index. Under the terms of the option agreements, the Group receives the average increase in the month-end value of the index in exchange for a fixed premium. The changes in fair value of the option agreements used to manage the exposure in the stock market in the certificates of deposit are recorded in earnings in accordance with SFAS No. 133, as amended.

Derivative instruments are generally negotiated over-the-counter (OTC) contracts. Negotiated OTC derivatives are generally entered into between two counterparties that negotiate specific contractual terms, including the underlying instrument, amount, exercise price and maturity.

Derivatives designated as a hedge consist of interest rate swaps primarily used to hedge securities sold under agreements to repurchase with notional amounts of $1.315 billion and $1.240 billion as of June 30, 2006 and December 31, 2005, respectively. Derivatives not designated as a hedge consist of purchased options used to manage the exposure to the stock market on stock indexed deposits with notional amounts of $146,090,000 and $173,280,000 as of June 30, 2006 and December 31, 2005, respectively; embedded options on stock indexed deposits with notional amounts of $137,995,000 and $164,651,000 as of June 30, 2006 and December 31, 2005, respectively; and interest rate swaps with notional amounts of $35 million as of June 30, 2006 and December 31, 2005.

During the six-month periods ended June 30, 2006 and 2005, gains (losses) of $859,000 and ($4.7 million), respectively, were credited (charged) to earnings and reflected as Derivatives Activities in the unaudited consolidated statements of income. During the six-month periods ended June 30, 2006 and 2005, unrealized gains of $18.0 million and unrealized losses of $7.0 million, respectively, on derivatives designated as cash flow hedges were included in other comprehensive income (loss).

At June 30, 2006 and December 31, 2005, the fair value of derivatives was recognized as either assets or liabilities in the unaudited consolidated statements of financial condition as follows: the fair value of the interest rate swaps to fix the cost of the forecasted rollover of short-term borrowings represented an asset of $20.3 million and $2.5 million, as of June 30, 2006 and December 31, 2005, respectively, presented in other assets; the purchased options used to manage the exposure to the stock market on stock indexed deposits represented an asset of $26.0 million and $22.1 million, respectively, also presented in other assets; the options sold to customers embedded in the certificates of deposit represented a liability of $24.6 million and $21.1 million, respectively, recorded in deposits.

The Group s Asset and Liability Management Committee (ALCO) decided in July 2006 to unwind interest rate swaps with an aggregate notional amount of $640 million, which had been designated as cash flow hedges and had maturity dates ranging from September 2010 to December 2010. Management concluded that it was beneficial to Oriental to lock-in the fair value of these swaps at approximately $11 million. The net gain of $11 million on this transaction will continue to be included in other comprehensive income, and will be reclassified into earnings during the originally remaining term of the swaps, starting in the September 2006 quarter and through December 2010, by reducing the interest expense on borrowings.

NOTE 9 SEGMENT REPORTING:

The Group segregates its businesses into the following major reportable segments: Banking, Treasury, and Financial Services. Management established the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. Other factors such as the Group s organization, nature of products, distribution channels and economic characteristics of the products were also considered in the determination of the reportable segments. The Group measures the performance of these reportable segments based on pre-established goals of different financial parameters such as net income, net interest income, loan production and fees generated. During this quarter, Management decided to reclassify and present investment banking revenues in the Treasury segment rather than into the Financial Services segment. This reclassification was retroactively presented in the disclosure.

Banking includes the Bank s branches and mortgage banking, with traditional banking products such as deposits and mortgage, commercial and consumer loans. Mortgage banking activities are carried out by the Bank s mortgage banking division, whose principal activity is to originate mortgage loans for the Group s own portfolio. From time to time, if conditions so warrant, the Group may sell loans directly into the secondary market or securitize conforming loans into mortgage-baked securities certificates. The Group outsourced the servicing of mortgages included in the resulting mortgage-backed securities pools, as well as loans maintained in portfolio.

The Treasury segment encompasses all of the Group s assets and liability management activities such as: purchases and sales of investment securities, interest rate risk management, derivatives, and borrowings as well as investment banking revenues on public offerings and private placement of debt and equity securities.

Financial services is comprised of the Bank s trust division (Oriental Trust), the brokerage subsidiary (Oriental Financial Services Corp.), the insurance agency subsidiary (Oriental Insurance, Inc.), and the pension plan administration subsidiary (Caribbean Pension Consultants, Inc.). The core operations of this segment are financial planning, money management and investment brokerage services, insurance sales, corporate and individual trust and retirement services, as well as pension plan administration services.

Intersegment sales and transfers, if any, are accounted for as if the sales or transfers were to third parties, that is, at current market prices. The accounting policies of the segments are the same followed by the Group, which are described in the Summary of Significant Accounting Policies included in the Group s Form 10-K. Following are the results of operations and the selected financial information by operating segment for the quarters and six-month periods ended June 30, 2006 and 2005:

Table of Contents

Unaudited quarters ended June 30, (Dollars in thousands)

	Banking	Treasury	Financial Services	Total Segments	Eliminations	Consolidated Total
June 30, 2006						
Interest income	$ 18,653	$ 38,191	$ 50	$ 56,894		**$ 56,894**
Interest expense	(6,831)	(39,355)		(46,186)		**(46,186)**
Net interest income	11,822	(1,164)	50	10,708		**10,708**
Non-interest income	4,111	112	3,298	7,521		**7,521**
Non-interest expenses	(12,082)	(314)	(2,388)	(14,784)		**(14,784)**
Intersegment revenue	576			576	(576)	
Intersegment expense		(240)	(336)	(576)	576	
Provision for loan losses	(947)			(947)		**(947)**
Income before income taxes	**$ 3,480**	**$ (1,606)**	**$ 624**	**$ 2,498**	**$**	**$ 2,498**
Total Assets as of June 30, 2006	**$1,583,909**	**$3,667,383**	**$12,265**	**$5,263,557**	**$(430,895)**	**$4,832,662**
June 30, 2005						
Interest income	$ 15,006	$ 33,857	$ 13	$ 48,876		**$ 48,876**
Interest expense	(5,386)	(24,202)		(29,588)		**(29,588)**
Net interest income	9,620	9,655	13	19,288		**19,288**
Non-interest income	4,348	(430)	2,519	6,437		**6,437**
Non-interest expenses	(10,163)	(596)	(3,134)	(13,893)		**(13,893)**
Intersegment revenue	1,193			1,193	(1,193)	
Intersegment expense		(347)	(846)	(1,193)	1,193	
Provision for loan losses	(850)			(850)		**(850)**

Income before income taxes	**$ 4,148**	**$ 8,282**	**$ (1,448)**	**$ 10,982**	**$**	**$ 10,982**
Total Assets as of June 30, 2005	**$ 973,296**	**$ 3,655,649**	**$ 9,582**	**$ 4,638,527**	**$ (391,662)**	**$ 4,246,865**

Table of Contents

Unaudited six-months period ended June 30, (Dollars in thousands)

	Banking	Treasury	Financial Services	Total Segments	Eliminations	Consolidated Total
June 30, 2006						
Interest income	$ 35,253	$ 77,547	$ 86	$ 112,886		**$ 112,886**
Interest expense	(12,833)	(74,133)		(86,966)		**(86,966)**
Net interest income	22,420	3,414	86	25,920		**25,920**
Non-interest income	7,544	3,062	5,868	16,474		**16,474**
Non-interest expenses	(24,247)	(697)	(4,723)	(29,667)		**(29,667)**
Intersegment revenue	1,189			1,189	(1,189)	
Intersegment expense		(407)	(782)	(1,189)	1,189	
Provision for loan losses	(2,048)			(2,048)		**(2,048)**
Income before income taxes	**$ 4,858**	**$ 5,372**	**$ 449**	**$ 10,679**	**$**	**$ 10,679**
Total Assets as of June 30, 2006	**$1,583,909**	**$3,667,383**	**$12,265**	**$5,263,557**	**$(430,895)**	**$4,832,662**
June 30, 2005						
Interest income	$ 28,577	$ 67,833	$ 38	$ 96,448		**$ 96,448**
Interest expense	(10,471)	(46,279)		(56,750)		**(56,750)**
Net interest income	18,106	21,554	38	39,698		**39,698**
Non-interest income	6,617	794	5,125	12,536		**12,536**
Non-interest expenses	(20,035)	(1,128)	(4,877)	(26,040)		**(26,040)**
Intersegment revenue	1,954			1,954	(1,954)	
Intersegment expense		(541)	(1,413)	(1,954)	1,954	
Provision for loan losses	(1,510)			(1,510)		**(1,510)**

Income before income taxes	**$ 5,132**	**$ 20,679**	**$ (1,127)**	**$ 24,684**	**$**	**$ 24,684**
Total Assets as of June 30, 2005	**$ 973,296**	**$3,655,649**	**$ 9,582**	**$4,638,527**	**$(391,662)**	**$4,246,865**

NOTE 10 RECENT ACCOUNTING DEVELOPMENTS:

SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140

In February 2006, FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. This statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 resolves issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS No. 155:

- Permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;
- Clarifies, which interest-only strips and principal-only strips are not subject to the requirements of Statement 133;
- Establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation;
- Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives;
- Amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of SFAS 155 may also be applied upon adoption of this statement for hybrid financial instruments that had been bifurcated under paragraph 12 of SFAS No. 133 prior to the adoption of SFAS No. 155. Earlier adoption is permitted as of the beginning of an entity s fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year.

Provisions of this statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis.

At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument should be recognized as a cumulative-effect adjustment to beginning retained earnings. An entity should separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods should not be restated.

The Group is evaluating the impact that this recently issued accounting pronouncement may have on its financial condition and results of operations.

SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statements No. 133 and 140

In March 2006, FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment to SFAS No. 140 , Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to (1) require the recognition of a servicing asset or servicing liability under specified circumstances, (2) require that, if practicable, all separately recognized servicing assets and liabilities be initially measured at fair value, (3) create a choice for subsequent measurement of each class of servicing assets or liabilities by applying either the amortization method or the fair value method, and (4) permit the one-time reclassification of securities identified as offsetting exposure to changes in fair value of servicing assets or liabilities from available-for-sale securities to trading securities under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. In addition, SFAS No. 156 amends SFAS No. 140 to require significantly greater disclosure concerning recognized servicing assets and liabilities. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006, with early adoption permitted.

The adoption of SFAS No. 156 is not expected to have a material effect on the Group s consolidated financial position or results of operations.

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes

During July 2006, the Financial Accounting Standards Board adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 was issued to clarify the requirements of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes , relating to the recognition of income tax benefits. FIN 48 provides a two-step approach to recognizing and measuring tax benefits when the benefits realization is uncertain. The first step is to determine whether the benefit is to be recognized; the second step is to determine the amount to be recognized:

Income tax benefits should be recognized when, based on the technical merits of a tax position, the entity believes that if a dispute arose with the taxing authority and were taken to a court of last resort, it is more likely than not (i.e. a probability of greater than 50 percent) that the tax position would be sustained as filed.

If a position is determined to be more likely-than not of being sustained, the reporting enterprise should recognize the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with the taxing authority.

FIN 48 is applicable to the Group beginning in the first quarter of 2007. The cumulative effect of applying the provisions of FIN 48 upon adoption must be reported as an adjustment to beginning retained earnings. Management is assessing the effect of the adoption of FIN 48 on the Group.

SFAS No. 157, Fair Value Measurements

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. Management is assessing the effect of the adoption of SFAS 157 on the Group.

Table of Contents

NOTE 11 RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

Subsequent to the issuance of the Group s June 30, 2005 consolidated financial statements, the Group s management determined that the accounting treatment for certain mortgage-related transactions previously treated as purchases under SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities , and the treatment of certain employee stock option awards as fixed awards instead of variable awards did not conform to GAAP, as discussed below. As a result, the accompanying unaudited consolidated financial statements as of June 30, 2005 have been restated from the amounts previously reported to correct the accounting for these transactions. Refer to Note 2 to the consolidated financial statements for the transition period ended December 31, 2005, included in the Group s Form 10-K.

A summary of the significant effects of the restatement as of June 30, 2005 is as follows:

	Quarter Ended June 30, 2005 (Unaudited)		Six-Month Period Ended June 30, 2005 (Unaudited)	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Non-interest expenses:				
Compensation and employees benefits	$ 7,366	$ 4,402	$ 13,984	$ 7,697
Total non-interest expenses	16,857	13,893	32,327	26,040
Income before income taxes	8,018	10,982	18,397	24,684
Net income	$ 7,641	$ 10,605	$ 20,691	$ 26,978
Income per common share:				
Basic	$ 0.26	$ 0.38	$ 0.74	$ 1.00
Diluted	$ 0.26	$ 0.37	$ 0.72	$ 0.96

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
SELECTED FINANCIAL DATA
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(dollars in thousands)

	Quarter Ended June 30,			Six-Month Period Ended June 30,		
	2006	2005	Variance %	2006	2005	Variance %
Interest income	$ 56,894	$ 48,876	16.4%	$ 112,886	$ 96,448	17.0%
Interest expense	46,186	29,588	56.1%	86,966	56,750	53.2%
Net interest income	**10,708**	**19,288**	**-44.5%**	**25,920**	**39,698**	**-34.7%**
Provision for loan losses	947	850	11.4%	2,048	1,510	35.6%
Net interest income after provision for loan losses	**9,761**	**18,438**	**-47.1%**	**23,872**	**38,188**	**-37.5%**
Non-interest income	7,521	6,437	16.8%	16,474	12,536	31.4%
Non-interest expenses	14,784	13,893	6.4%	29,667	26,040	13.9%
Income before taxes	**2,498**	**10,982**	**-77.3%**	**10,679**	**24,684**	**-56.7%**
Income tax (benefit) expense	(21)	377	-105.6%	110	(2,294)	-104.8%
Net income	**2,519**	**10,605**	**76.2%**	**10,569**	**26,978**	**-60.8%**
Less: Dividends on preferred stock	(1,201)	(1,202)	-0.1%	(2,401)	(2,401)	0.0%
Net income available to common shareholders	**$ 1,318**	**$ 9,403**	**-86.0%**	**$ 8,168**	**$ 24,577**	**-66.8%**
Per share data:						
Basic	$ 0.05	$ 0.38	**-86.8%**	$ 0.33	$ 1.00	**-67.0%**
Diluted	$ 0.05	$ 0.37	**-86.5%**	$ 0.33	$ 0.96	**-65.6%**
Average common shares outstanding	24,599	24,847	-1.0%	24,608	24,571	0.2%
Average potential common share-options	106	601	82.4%	128	1,104	-88.4%
Average shares and shares equivalents	24,705	25,448	**-2.9%**	24,736	25,675	**-3.7%**

Selected Financial Ratios:				
Return on average assets (ROA)	0.22%	1.01%	0.92%	1.29%
Return on average equity (ROE)	1.94%	13.86%	7.93%	18.22%
Efficiency ratio	78.76%	53.58%	71.39%	49.52%
Expense ratio	0.60%	0.71%	0.63%	0.65%
Interest rate spread	0.70%	1.68%	0.89%	1.75%
Interest rate margin	0.96%	1.89%	1.16%	1.95%
Number of financial centers			24	23

PERIOD END BALANCES AND CAPITAL RATIOS:

	June 30, 2006	December 31, 2005	Variance %
Investments and loans			
Investment securities	$ 3,497,822	$ 3,476,767	0.6%
Loans and leases (including loans held-for-sale), net	1,153,938	903,308	27.7%
Securities sold but not yet delivered	710	44,009	-98.4%
	$ 4,652,470	**$ 4,424,084**	**5.2%**
Deposits and Borrowings			
Deposits	$ 1,213,847	$ 1,298,568	-6.5%
Repurchase agreements	2,856,361	2,427,880	17.6%
Other borrowings	389,764	404,921	-3.7%
Securities purchased but not yet received	6,539	43,354	-84.9%
	$ 4,466,511	**$ 4,174,723**	**7.0%**
Stockholders equity			
Preferred equity	$ 68,000	$ 68,000	0.0%
Common equity	272,283	273,791	-0.6%
	$ 340,283	**$ 341,791**	**-0.4%**
Capital ratios			
Leverage capital	**9.39%**	**10.13%**	**-7.3%**

Tier 1 risk-based capital	**29.60%**	**34.70%**	**-14.7%**
Total risk-based capital	**30.11%**	**35.22%**	**-14.5%**
Common shares outstanding	**24,562**	**24,580**	**-0.1%**
Trust assets managed	$ 1,933,912	$ 1,875,300	3.1%
Broker-dealer assets gathered	1,172,726	1,132,286	3.6%
Assets managed	**3,106,638**	**3,007,586**	**3.3%**
Assets owned	4,832,662	4,546,949	6.3%
Total financial assets managed and owned	**$ 7,939,300**	**$ 7,554,535**	**5.1%**

OVERVIEW OF FINANCIAL PERFORMANCE

Introduction

The Group s diversified mix of businesses and products generates both the interest income traditionally associated with a banking institution and non-interest income traditionally associated with a financial services institution (generated by such businesses as securities brokerage, fiduciary services, investment banking, insurance and pension administration). Although all of these businesses, to varying degrees, are affected by interest rate and financial markets fluctuations and other external factors, the Group s commitment is to produce a balanced and growing revenue stream.

During the quarter and six-month period ended June 30, 2006, the Group continued to implement the Oriental Way program to deliver world-class products and services, targeting the personal and commercial needs of Puerto Rico s mid net-worth individuals, professionals and owners of small and mid-sized businesses. The results of these efforts included continued growth in commercial loans and tight control over non-interest expenses.

Change of Fiscal Year

On August 30, 2005, the Group s Board of Directors approved an amendment to Section 1 of Article IX of the Group s By-Laws to change its fiscal year to a calendar year. The Group s fiscal year was from July 1 of each year to June 30 of the following year. The Group s transition period was from July 1, 2005 to December 31, 2005.

Net Income

For the quarter and six-month period ended June 30, 2006, the Group s net income available to common shareholders totaled $1.3 million and $8.2 million, respectively, compared to $9.4 million and $24.6 million in the comparable year ago periods. Earnings per common share fully diluted was $0.05 compared to $0.37 in the year-ago quarter and $0.33 compared to $0.96 in the year ago six-month period. As a result of the Group s previously disclosed restatement, the year ago quarter and six-month period included a $3.0 million and $6.3 million reduction, respectively, in non-cash compensation expense. These reductions increased income available to common shareholders by $0.12 and $0.25 per common share fully diluted in the quarter and six-month period, respectively.

Return on Assets and Common Equity

Return on common equity (ROE) and return on assets (ROA) for the quarter and six-month period ended June 30, 2006 were 1.94%, 0.22%, 7.93% and 0.92%, respectively, which represent decreases of 86.0% and 56.5% in ROE from 13.86% and 18.22% for the quarter and six-month period ended June 30, 2005, and a decrease of 78.2% and 28.7% in ROA from 1.01% and 1.29% for the quarter and six-month period ended June 30, 2005, mainly due to reduced net income available to common shareholders.

Net Interest Income after Provision for Loan Losses

Net interest income after provision for loan losses decreased 47.1% and 37.5% for the quarter and six-month period ended June 30, 2006, totaling $9.8 million and $23.9 million, compared with $18.4 million and $38.2 million for the same periods in the previous year. Increases of 16.4% and 17.0% in interest income for the quarter and six-month period ended June 30, 2006 as compared to same periods last year was mainly due to higher loan volume, and higher average yields on both investment securities and loans. These increases were more than offset by higher interest rates and increased volume on borrowings. Net interest margin for the June 30, 2006 quarter and six-month period was 0.96% and 1.16%, respectively compared to 1.89% and 1.95% for the quarter and six-month period. Investment yields increased despite the Group s continued repositioning of its portfolio, shifting into short-term government securities and away from long-term, mortgage-backed securities. Interest income from commercial and consumer loans also increased on both increased volume and yields.

Non-Interest Income

Total non-interest income was $7.5 million and $16.5 million, an increase of 16.8% and 31.4% over the June 2005 quarter and six-month period, respectively. Financial service revenues totaled $4.1 million and $7.3 million compared to $3.2 million and $6.4 million in the year ago quarter and six-month period, respectively, while banking service revenues totaled $2.5 million and $4.7 million versus $2.1 million and $3.9 million in the June 2005 quarter and six-month period then ended, respectively. Investment banking revenues totaled $0.9 million and $2.6 million, versus $0.2 million and $0.3 million in the June 2005 quarter and six-month period, respectively. Mortgage banking activities totaled $0.6 million and $1.1 million, versus $1.2 million and $2.2 million in the June 2005 quarter and six-month period then ended, respectively. Combined (losses) gains from net (loss) gain on sale of securities, derivatives and other totaled ($0.5 million) and $0.8 million, versus ($0.2 million) and ($0.4 million) in the June 2005 quarter and six-month period, respectively. Improvements of both items reflect the SWAP program mark to market valuation of financial instruments put in place last year to offset partially the effect of rising rates on interest expense.

Non-Interest Expenses

Non-interest expenses totaled $14.8 million and $29.7 million, compared to $13.9 million and $26.0 million, in the June 2005 quarter and six-month period, respectively. The June 2006 quarter reflected sequential declines in compensation expense (excluding non-cash compensation reduction); advertising and business promotion expenses;

professional and service fees; and other costs. Even though these expenses declined, non-interest expenses did include higher accounting fees related to the Group s change in its fiscal year; start-up expenses related to new and expanded branches; and acceleration of amortization of existing leasehold improvements related to the Group s May 2006 move to new corporate offices, where most non-branch operations have been consolidated for increased efficiencies. Compensation and employee benefit expense for the last year s quarter and six-month period includes reduction in non-cash compensation expense of $3.0 million and $6.3 million, respectively, due to the Group s previously disclosed restatement.

Income Tax Expense

The income (benefit) tax expense was ($21,000) and $110,000 for the quarter and six-month period June 30, 2006, respectively, compared to $377,000 and ($2.3 million) for the same periods ended June 30, 2005. The current income tax provision is lower than the provision based on the statutory tax rate for the Group, which is 43.5%, due to the high level of tax-advantaged interest income earned on certain investments and loans, net of the disallowance of related expenses attributable to the exempt income. Exempt interest relates principally to interest earned on obligations of the United States and Puerto Rico governments and certain mortgage-backed securities, including securities held by the Group s international banking entities. The tax benefit for the quarter ended June 30, 2005 takes into account, among other things, the expiration of certain tax contingencies.

Group s Financial Assets

The Group s total financial assets include owned assets and the assets managed by the trust division, the securities broker-dealer subsidiary, and the private pension plan administration subsidiary. At June 30, 2006, total financial assets reached $7.940 billion compared to $7.555 billion at December 31, 2005, reflecting a 5.1% increase. There was 3.3% increase in assets managed by the trust division and broker-dealer subsidiary when compared to December 31, 2005. Owned assets, the Group s largest financial asset component, are approximately 99% owned by the Group s banking subsidiary.

The Group s second largest financial asset component is assets managed by the trust division and the retirement plan administration subsidiary. The Group s trust division offers various types of individual retirement accounts (IRA) and manages 401(K) and Keogh retirement plans and custodian and corporate trust accounts, while Caribbean Pension Consultants, Inc. (CPC) manages the administration of private pension plans. At June 30, 2006, total assets managed by the Group s trust division and CPC amounted to $1.934 billion, compared to the $1.875 billion reported at December 31, 2005. The other financial asset component is assets gathered by the securities broker-dealer. The Group s securities broker-dealer subsidiary offers a wide array of investment alternatives to its client base such as tax-advantaged fixed income securities, mutual funds, stocks, bonds and money management wrap-fee programs. At June 30, 2006, total assets gathered by the securities broker-dealer from its customer investment accounts, increased to $1.173 billion compared to $1.132 billion as of December 31, 2005. Both financial asset components reflect the Group s success attracting financial assets, as well as improved equity market conditions.

Interest Earning Assets

The investment portfolio amounted to $3.498 billion as of June 30, 2006, a 0.6% increase compared to $3.477 billion as of December 31, 2005, while the loan portfolio increased 27.7% to $1.154 billion as of June 30, 2006, compared to $903.3 million as of December 31, 2005. The nominal sequential change in investment securities reflects the Group s strategy of growing loans faster than investment securities.

Mortgage loans totaled $897.2 million as of June 30, 2006, a 38.2% increase from $649.1 million at December 31, 2005, and 38.8% increase from $646.4 million a year ago. Mortgage loan production totaled $70.8 million and $134.0 million, a 9.1% and 4.6% decrease compared to the same quarter and six-month period of the prior fiscal year, excluding purchases from third party originators. Mortgage loans purchased amounted to $174.2 million and $181.8 million for the quarter and six-month period ended June 30, 2006, respectively, compared to $22.2 million and $37.8 million for the June 2005 periods.

Interest Bearing Liabilities

Deposits of $1.214 billion at June 30, 2006 decreased 6.5% compared to December 31, 2005, reflecting reduced IRA CD balances as the Group s customers transferred funds into Oriental s Diversified Growth IRA investment product, partially offset by the success of Oriental s new savings account products. Borrowings at June 30, 2006 totaled $3.246 billion, an increase of 14.6% from December 31, 2005, primarily due to the Group s use of repurchase agreements. While the Group s long-term strategy is to use deposits rather than borrowings to fund asset growth, from time to time it is more cost effective for the Group to use repurchase agreements.

Stockholders Equity

Stockholders equity as of June 30, 2006, was $340.3 million, slightly lower than the $341.8 million as of December 31, 2005.

On August 30, 2005, the Board of Directors of the Group approved a program for the repurchase of up to $12.1 million of the Group s outstanding shares of common stock, which replaced the former program. On June 20, 2006, the Board of Directors approved an increase of $3.0 million to the initial amount, for the repurchase of up to $15.1 million. During the quarter and six-month period ended June 30, 2006, the Group repurchased 46,600 of its shares of common stock in the open market, at a total cost of $582,000.

The Group continues to be well-capitalized, with ratios significantly above regulatory capital adequacy guidelines. At June 30, 2006, Tier 1 Leverage Capital Ratio was 9.39% (more than 2.3 times the minimum of 4.00%), Tier 1 Risk-Based Capital Ratio was 29.60% (more than 7.4 times the minimum of 4.00%), and Total Risk-Based Capital Ratio was 30.11% (more than 3.7 times the minimum of 8.00%).

Dividends

During the quarter and six-month period ended June 30, 2006, the Group declared cash dividends of $3.4 million and $1.2 million and $6.9 million and $2.4 million on its common and preferred stocks, respectively, similar to the $3.5 million and $1.2 million and $6.9 million and $2.4 million declared for the same periods a year ago.

Table of Contents

TABLE 1 QUARTERLY ANALYSIS OF NET INTEREST INCOME AND CHANGES DUE TO VOLUME/RATE
FOR THE QUARTERS ENDED JUNE 30, 2006 AND 2005
(Dollars in thousands)

	Interest			Average rate			Average balance		
	2006	**2005**	**Variance in %**	**2006**	**2005**	**Variance in BP**	**2006**	**2005**	**Variance in %**
A TAX EQUIVALENT SPREAD									
Interest-earning assets	$56,894	$48,876	16.4%	5.08%	4.78%	30	$4,480,608	$4,091,543	9.5%
Tax equivalent adjustment	13,051	10,523	24.0%	1.17%	1.03%	14			0.0%
Interest-earning assets tax equivalent	**69,945**	**59,399**	**17.8%**	**6.25%**	**5.81%**	**44**	**4,480,608**	**4,091,543**	**9.5%**
Interest-bearing liabilities	46,186	29,588	56.1%	4.38%	3.10%	128	4,215,139	3,814,410	10.5%
Tax equivalent net interest income / spread	**$23,759**	**$29,811**	**-20.3%**	**1.87%**	**2.71%**	**(84)**	**$ 265,469**	**$ 277,133**	**-4.2%**
Tax equivalent interest rate margin				**2.13%**	**2.92%**	**(79)**			
B NORMAL SPREAD									
Interest-earning assets:									
Investments:									
Investment securities	$38,251	$34,153	12.0%	4.44%	4.32%	12	$3,443,554	$3,165,901	8.8%
Investment management fees	(395)	(495)	-20.2%	-0.05%	-0.06%	1			0.0%
Total investment securities	37,856	33,658	12.5%	4.40%	4.25%	15	3,443,554	3,165,901	8.8%
Trading securities	4	5	-20.0%	7.34%	5.99%	135	218	334	-34.7%
Money market investments	723	279	159.1%	4.72%	2.97%	175	61,269	37,583	63.0%

	38,583	**33,942**	**13.7%**	**4.40%**	**4.24%**	**16**	**3,505,041**	**3,203,818**	**9.4%**
Loans:									
Mortgage	13,003	11,030	17.9%	7.28%	7.05%	23	714,649	625,556	14.2%
Commercial	4,202	3,190	31.7%	7.55%	5.43%	212	222,574	235,023	-5.3%
Consumer	1,106	714	54.9%	11.54%	10.52%	102	38,344	27,146	41.3%
	18,311	**14,934**	**22.6%**	**7.51%**	**6.73%**	**78**	**975,567**	**887,725**	**9.9%**
	56,894	**48,876**	**16.4%**	**5.08%**	**4.78%**	**30**	**4,480,608**	**4,091,543**	**9.5%**
Interest-bearing liabilities:									
Deposits:									
Non-interest bearing deposits			0.0%			0	39,897	64,573	-38.2%
Now Accounts	214	232	-7.8%	1.07%	1.05%	2	80,077	88,357	-9.4%
Savings	1,014	236	329.7%	2.87%	1.01%	186	141,139	93,705	50.6%
Certificates of Deposit	9,918	8,229	20.5%	4.12%	3.41%	71	961,794	964,839	-0.3%
	11,146	**8,697**	**28.2%**	**3.65%**	**2.87%**	**78**	**1,222,907**	**1,211,474**	**0.9%**
Borrowings:									
Repurchase agreements	32,932	16,598	98.4%	5.04%	3.01%	203	2,616,058	2,202,757	18.8%
Interest rate risk management	(1,930)	819	-335.7%	-0.30%	0.15%	(45)			0.0%
Financing fees	126	166	-24.1%	0.02%	0.03%	(1)			0.0%
Total repurchase agreements	**31,128**	**17,583**	**77.0%**	4.76%	3.19%	157	**2,616,058**	**2,202,757**	**18.8%**
FHLB advances	2,248	2,001	12.3%	3.22%	2.60%	62	279,497	308,389	-9.4%
Subordinated capital notes	1,344	1,166	15.3%	7.45%	6.46%	99	72,166	72,166	0.0%
Term Notes	159	107	48.6%	4.24%	2.85%	139	15,000	15,000	0.0%
Other borrowings	161	34	373.5%	6.77%	2.98%	379	9,511	4,624	105.7%
	35,040	**20,891**	**67.7%**	**4.68%**	**3.21%**	**147**	**2,992,232**	**2,602,936**	**15.0%**
	46,186	**29,588**	**56.1%**	**4.38%**	**3.10%**	**128**	**4,215,139**	**3,814,410**	**10.5%**
Net interest income / spread	**$10,708**	**$19,288**	**-44.5%**	**0.70%**	**1.68%**	**(98)**			
Interest rate margin				**0.96%**	**1.89%**	**(93)**			

Excess of average interest-earning assets over average interest-bearing liabilities	**$ 265,469**	**$ 277,133**	**-4.2%**
Average interest-earning assets over average interest-bearing liabilities ratio	**106.30%**	**107.27%**	

C. Changes in net interest income due to:	**Volume**	**Rate**	**Total**
Interest Income:			
Investments	13,617	(8,976)	4,641
Loans	$ 1,884	$ 1,493	$ 3,377
	15,501	**(7,483)**	**8,018**
Interest Expense:			
Deposits	$ 325	2,124	2,449
Repurchase agreements	9,187	4,358	13,545
Other borrowings	(833)	1,437	604
	8,679	**7,919**	**16,598**
Net Interest Income	**$ 6,822**	**$ (15,402)**	**$ (8,580)**

Table of Contents

TABLE 1A FISCAL YEAR-TO-DATE ANALYSIS OF NET INTEREST INCOME AND CHANGES DUE TO VOLUME/RATE
FOR THE SIX-MONTHS RERIOD ENDED JUNE 30, 2006 AND 2005
(Dollars in thousands)

	Interest			Average rate			Average balance		
	2006	2005	Variance in %	2006	2005	Variance in BP	2006	2005	Variance in %
A TAX EQUIVALENT SPREAD									
Interest-earning assets	$112,886	$ 96,448	17.0%	5.06%	4.74%	32	$4,461,132	$4,072,091	9.6%
Tax equivalent adjustment	26,773	21,244	26.0%	1.20%	1.04%	16			0.0%
Interest-earning assets tax equivalent	**139,659**	**117,692**	**18.7%**	**6.26%**	**5.78%**	**48**	**4,461,132**	**4,072,091**	**9.6%**
Interest-bearing liabilities	86,966	56,750	53.2%	4.17%	2.99%	118	4,168,052	3,795,220	9.8%
Tax equivalent net interest income / spread	**$ 52,693**	**$ 60,942**	**-13.5%**	**2.09%**	**2.79%**	**(70)**	**$ 293,080**	**$ 276,871**	**5.9%**
Tax equivalent interest rate margin				**2.36%**	**2.99%**	**(63)**			
B NORMAL SPREAD									
Interest-earning assets:									
Investments:									
Investment securities	$ 77,570	$ 68,671	13.0%	4.50%	4.31%	19	$3,447,122	$3,189,098	8.1%
Investment management fees	(714)	(941)	-24.1%	-0.04%	-0.06%	2			0.0%
Total investment securities	76,856	67,730	13.5%	4.46%	4.25%	21	3,447,122	3,189,098	8.1%
	3	6	-50.0%	3.30%	3.50%	(20)	182	343	-46.9%

Trading securities									
Money market investments	1,463	355	312.6%	4.50%	2.23%	227	65,019	31,787	104.5%
	78,322	**68,091**	**15.0%**	**4.46%**	**4.23%**	**23**	**3,512,323**	**3,221,228**	**9.0%**
Loans:									
Mortgage	24,201	21,494	12.6%	6.75%	6.63%	12	716,601	648,321	10.5%
Commercial	8,298	5,560	49.2%	8.51%	6.30%	221	194,913	176,474	10.4%
Consumer	2,065	1,303	58.5%	11.08%	10.00%	108	37,295	26,068	43.1%
	34,564	**28,357**	**21.9%**	**7.29%**	**6.67%**	**62**	**948,809**	**850,863**	**11.5%**
	112,886	**96,448**	**17.0%**	**5.06%**	**4.74%**	**32**	**4,461,132**	**4,072,091**	**9.6%**
Interest-bearing liabilities:									
Deposits:									
Non-interest bearing deposits			0.0%			0	40,965	59,314	-30.9%
Now Accounts	433	462	-6.4%	1.05%	1.04%	1	82,617	88,627	-6.8%
Savings	1,271	469	171.0%	2.24%	1.00%	124	113,717	93,824	21.2%
Certificates of Deposit	19,940	15,389	29.6%	4.01%	3.36%	65	993,618	916,577	8.4%
	21,644	**16,320**	**32.6%**	**3.52%**	**2.82%**	**70**	**1,230,917**	**1,158,342**	**6.3%**
Borrowings:									
Repurchase agreements	60,487	30,890	95.8%	4.75%	2.76%	199	2,548,638	2,240,004	13.8%
Interest rate risk management	(3,250)	2,742	-218.5%	-0.26%	0.24%	(50)			0.0%
Financing fees	254	337	-24.6%	0.02%	0.03%	(1)			0.0%
Total repurchase agreements	**57,491**	**33,969**	**69.2%**	4.51%	3.03%	148	**2,548,638**	**2,240,004**	**13.8%**
FHLB advances	4,597	3,960	16.1%	3.15%	2.58%	57	292,213	307,383	-4.9%
Subordinated capital notes	2,641	2,273	16.2%	7.32%	6.30%	102	72,166	72,166	0.0%
Term Notes	316	194	62.9%	4.21%	2.59%	180	15,000	15,000	21.2%
Other borrowings	277	34	714.7%	6.08%	2.92%	362	9,118	2,325	155.1%
	65,322	**40,430**	**61.6%**	**4.45%**	**3.07%**	**138**	**2,937,135**	**2,636,878**	**11.4%**

	86,966	**56,750**	**53.2%**	**4.17%**	**2.99%**	**118**	**4,168,052**	**3,795,220**	**9.8%**
Net interest income / spread	**$ 25,920**	**$ 39,698**	**-34.7%**	**0.89%**	**1.75%**	**(86)**			
Interest rate margin				**1.16%**	**1.95%**	**(79)**			
Excess of average interest-earning assets over average interest-bearing liabilities							**$ 293,080**	**$ 276,871**	**5.9%**
Average interest-earning assets over average interest-bearing liabilities ratio							**107.03%**	**107.30%**	

C. Changes in net interest income due to:	**Volume**	**Rate**	**Total**
Interest Income:			
Investments	28,060	(17,829)	10,231
Loans	$19,398	$(13,191)	$ 6,207
	47,458	**(31,020)**	**16,438**
Interest Expense:			
Deposits	$ 3,747	1,577	5,324
Repurchase agreements	15,125	8,397	23,522
Other borrowings	(556)	1,926	1,370
	18,316	**11,900**	**30,216**
Net Interest Income	**$29,142**	**$(42,920)**	**$(13,778)**

-26-

Net interest income is a function of the difference between rates earned on the Group s interest-earning assets and rates paid on its interest-bearing liabilities (interest rate spread) and the relative amounts of its interest-earning assets and interest-bearing liabilities (interest rate margin). Typically, bank liabilities re-price in line with changes in short-term rates, while many asset positions are affected by longer-term rates. The Group constantly monitors the composition and re-pricing of its assets and liabilities to maintain its net interest income at adequate levels.

For the quarter and six-month period ended June 30, 2006, net interest income amounted to $10.7 million and $25.9 million, respectively, a 44.5% and 34.8% decrease from $19.3 million and $39.7 million in the same period of the previous year. The decrease for the quarter reflects a 16.4% increase in interest income, due to a $15.5 million positive volume variance and a $7.5 million negative rate variance, more than offset by an increase of 56.1% in interest expense, caused by an increase of $8.7 million from borrowings volume and $7.9 million due to interest rate changes. The decrease for the six-month period reflects a 17.0% increase in interest income, due to a $47.5 million positive volume variance and a $31.0 million negative interest rate variance, offset by an increase of 53.2% in interest expense, caused by an increase of $18.3 million from borrowings volume and $11.9 million attributable to interest rate changes. Interest rate spread dropped 98 basis points, to 0.70% from 1.68% in the June 2005 quarter, and 86 basis points to 0.89% from 1.75% in the six-month period ended June 2005. This decline was due to an increase of 30 and 32 basis points, respectively, in the combined average yield of investments and loans for the quarters and six-month periods and an increase of 128 and 118 basis points, respectively, caused by an increase in the average cost of funds.

For the quarter and six-month period ended June 30, 2006, the average balance of total interest-earnings assets grew 9.5% to $4.481 billion versus $4.092 billion and 9.6% to $4.461 billion compared to $4.072 billion for the same periods of the previous year. The increase in the average balance reflects growth of 9.4% in the investment portfolio to $3.505 billion and a 9.9%in loans, to $975.6 million for the quarter, and 9.0% in the investment portfolio to $3.512 billion, and 11.5% in loans, to $948.8 million for the six-month period. Most of the dollar increase in loans came from the residential mortgage loan portfolio average balance, which increased by 14.2% to $714.6 million for the quarter ended June 30, 2006 from $625.6 million for the quarter ended June 30, 2005 and 10.5% to $716.6 million for the six-month period ended June 30, 2006 from $648.3 million a year ago.

For the quarter and six-month period ended June 30, 2006, the average yield on interest-earning assets was 5.08%and 5.06%, respectively, compared to 4.78% and 4.74% in the comparable year ago periods. Higher average yields were due to increases in both of the investments and loan portfolio yields. The investment portfolio yield increased to 4.40% in the quarter ended June 30, 2006, versus 4.24% in the corresponding year ago quarter and to 4.46% in the six-month period ended June 30, 2006, versus 4.23% in the corresponding period a year ago, due to additions of higher yield investments. The increase of 78 basis points in the yield of the loan portfolio for the quarter and 62 basis points for the six-month period was due to higher rates on mortgage, commercial and consumer loans new production reflecting higher rates on variable rate loans due to the higher interest rate environment for lending.

For the quarter and six-month period ended June 30, 2006, interest expense increased 56.1% to $46.2 million from $29.6 million for the year ago quarter and 53.2% to $87.0 million from $56.8 million for the year ago six-month period, both resulting from higher volume and rate variances due to the increased interest earnings asset portfolio.

For the quarter and six-month period ended June 30, 2006, the cost of deposits increased 78 basis points to 3.65% as compared to 2.87% in the year ago quarter and 70 basis points to 3.52% as compared to 2.82% in the year ago six-month period. The increase reflects higher average rates paid on higher balances, specifically in savings accounts.

For the quarter and six-month period ended June 30, 2006, the cost of borrowings increased 147 basis points to 4.68% as compared to 3.21% in the year ago quarter and 138 basis points to 4.45% as compared to 3.07% in the year ago six-month period. The increase was mainly the result of higher average rates paid on increased volume of repurchase agreements. Repurchase agreements increased 203 basis points, to 5.04% from 3.01% for the quarter ended June 30, 2005 and 199 basis points to 4.75% as compared to 2.76% in the year ago six-month period, reflecting the effect of interest rate increases by the Board of Governors of the Federal Reserve System of 300 basis points since December 2004. The cost of repurchase agreements was offset by a 45 basis point reduction in the Group s hedging costs for the quarter ended June 30, 2006 and 50 basis points for the six-month period, as the Group s use of interest rate swaps in a rising interest rate environment partially offset rising borrowing costs. The cost of FHLB advances increased 62 basis points to 3.22% versus 2.60% for the quarter ended June 30, 2005, and 57 basis points to 3.15% as compared to 2.58%

in the year ago six-month period.

Table of Contents

TABLE 2 NON-INTEREST INCOME SUMMARY:
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(Dollars in thousands)

	Quarter Ended June 30,			Six-Month Period Ended June 30,		
	2006	**2005**	**Variance %**	**2006**	**2005**	**Variance %**
Mortgage banking activities	$ 634	$ 1,168	-45.7%	$ 1,070	$ 2,241	-52.3%
Commissions and fees from broker, insurance activities	4,066	3,249	25.1%	7,317	6,419	14.0%
Investment banking revenues	852	162	425.9%	2,561	339	655.5%
Non-banking service revenues	5,552	4,579	21.2%	10,948	8,999	21.7%
Fees on deposit accounts	1,315	1,233	6.7%	2,734	2,392	14.3%
Bank service charges and commissions	656	367	78.7%	1,275	929	37.2%
Other operating revenues	540	464	16.2%	678	572	18.5%
Bank service revenues	2,511	2,064	21.6%	4,687	3,893	20.4%
Securities net gain		1,420	-100.0%	19	4,056	-99.5%
Trading net (loss) gain	(8)	(42)	-81.0%	21	(53)	-139.6%
Derivatives net (loss) gain	(23)	(1,866)	-98.8%	859	(4,670)	-118.4%
Securities, derivatives and trading activities	(31)	(488)	-93.6%	899	(667)	234.8%
Other income (loss)	(511)	282	-281.2%	(60)	311	-119.3%
Other non-interest income	(511)	282	-281.2%	(60)	311	-119.3%
Total non-interest income	**$ 7,521**	**$ 6,437**	**16.8%**	**$ 16,474**	**$ 12,536**	**31.4%**

Non-interest income, the second largest source of earnings, is affected by the amount of securities and trading transactions, the level of trust assets under management, transactions generated by the gathering of financial assets by the securities broker-dealer subsidiary, the level of investment and mortgage banking activities, and the fees generated from loans, deposit accounts, and insurance.

Non-interest income totaled $7.5 million and $16.5 million in the quarter and six-months ended June 30, 2006, respectively a 16.8% and 31.4% increase when compared to $6.4 million and $12.5 million in the same periods of the previous year. Performance in the quarter and six-months ended June 30, 2006, reflects increases in commissions and fees from brokerage investment banking, and insurance activities reflecting increased activities from the financial services area, as well as higher banking service revenues. This was partially offset by less mortgage banking activities, primarily reflecting the Group s strategy, initiated during the quarter ended June 30, 2005, to retain more mortgages for their recurring interest income rather than selling the loans for a gain.

Non-banking service revenues, generated from trust, mortgage banking, investment banking, brokerage, and insurance activities, is one of the principal components of non-interest income. For the quarter and six-month period ended June 30, 2006, these revenues increased 21.2% and 21.7% to $5.6 million and $10.9 million, respectively, from $4.6 million and $9.0 million for the year ago periods. Mortgage banking activities decreased 45.7%, to $634,000 from $1.2 million in the year ago quarter and 52.3%, to $1.1 million from $2.2 million in the year ago six-month period. Commissions and fees from brokerage and insurance activities increased 25.1% to $4.1 million from $3.2 million in the year ago quarter and 14.0%, to $7.3 million from $6.4 million in the year ago six-month period. Growth reflected the general improvement in the equity markets and increased underwriting activities. Investment banking revenues increased to $852,000 from $162,000 the year ago quarter and to $2.6 million from $339,000 the year ago six-month period.

Banking service revenues, another major component of non-interest income, consists primarily of fees generated by deposit accounts, electronic banking services, and bank service commissions. For the quarter and six-month period ended June 30, 2006, these revenues increased 21.6% to $2.5 million compared to the year ago quarter and 20.4% to $4.7 million the year ago six-month period, primarily due to increase in fee income on deposit accounts, mainly overdraft fees, and the ongoing success of the Group s product and service marketing programs. Fees on deposit accounts increased 6.7% to $1.3 million from $1.2 million in the year ago quarter and 14.3% to $2.7 million from $2.4 million in the year ago six-month period. Bank service charges and commissions increased 78.7% to $656,000 from $367,000 in the year ago quarter and 37.2% to $1.3 million from $929,000 in the year ago reflecting higher transactional volume in the Bank s debit and credit cards.

For the quarter ended June 30, 2006, (losses) gains from securities, derivatives and trading activities was ($31,000) compared to ($488,000) for the year ago quarter and $899,000 compared to ($667,000) for the year ago six-month period. The improvement for both periods was primarily due to higher mark to market valuation of financial instruments used to partially offset the effect of rising rates on interest expense.

TABLE 3 NON-INTEREST EXPENSES SUMMARY
FOR THE QUARTER AND SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(Dollars in thousands)

	Quarter Ended June 30,			Six-Month Period Ended June 30,		
	2006	**2005**	**Variance %**	**2006**	**2005**	**Variance %**
Compensation and employee benefits	$ 5,627	$ 4,402	27.8%	$ 11,801	$ 7,697	53.3%
Occupancy and equipment	2,793	3,066	-8.9%	5,682	5,532	2.7%
Advertising and business promotion	1,300	1,420	-8.5%	2,366	2,907	-18.6%
Professional and service fees	1,601	1,777	-9.9%	3,225	3,614	-10.8%
Communications	395	410	-3.7%	843	786	7.3%
Loan servicing expenses	509	430	18.4%	964	831	16.0%
Taxes, other than payroll and income taxes	573	471	21.7%	1,173	934	25.6%
Electronic banking charges	494	543	-9.0%	962	1,060	-9.2%
Printing, postage, stationery and supplies	359	207	73.4%	544	416	30.8%
Insurance, including deposits insurance	219	188	16.5%	432	375	15.2%
Other operating expenses	914	979	-6.6%	1,675	1,888	-11.3%
Total non-interest expenses	**$ 14,784**	**$ 13,893**	**6.4%**	**$ 29,667**	**$ 26,040**	**13.9%**
Relevant ratios and data:						
Compensation and benefits to non-interest expenses	**38.1%**	**31.7%**		**39.8%**	**29.6%**	
Compensation to total assets	**0.47%**	**0.41%**		**0.49%**	**0.36%**	
Average compensation per employee (annualized)	**$ 42.4**	**$ 33.8**		**$ 44.6**	**$ 28.9**	
Average number of employees	**531**	**521**		**529**	**532**	
Bank assets per employee	**$ 9,101**	**$ 8,151**		**$ 9,177**	**$ 7,983**	

Total work force:	**537**	**519**

Non-interest expenses for the quarter and six-month period ended June 30, 2006, were $14.8 million and $29.7 million, respectively, compared to $13.9 million and $26.0 million in the year ago periods, with an efficiency ratio of 78.76% compared to 53.58% in the quarter ended June 30, 2005 and 71.39% compared to 49.52% for the six-month period ended June 30, 2005. The efficiency ratio measures how much of a company s revenue is used to pay operating expenses. The Group computes its efficiency ratio by dividing operating expenses by the sum of its net interest income and recurring non-interest income, but excluding gains on sale of investments securities, derivatives gains or losses and other income.

The Group has been successful in limiting expense growth to those areas that directly contribute to increase efficiency, service quality, and profitability. Non-interest expenses increased 6.4% and 13.9%, respectively, compared to the year ago quarter and six months ended June 30, 2005, which included a non-cash compensation benefit of $3.0 million and $6.3 million, respectively, as a result of the Group s previously disclosed restatement. Excluding the year ago non-cash compensation benefit, non interest expense declined 12.3% and 8.2%, respectively, from the comparable year ago periods.

Compensation and employee benefits, the largest non-interest expense category accounted for 38.1% and 39.8% of the total non-interest expense, for the quarter and six-month period ended June 30, 2006, respectively. Total compensation and employee benefits amounted to $5.6 million and $11.8 million, respectively, for the quarter and six-month period ended June 30, 2006, compared to $4.4 million and $11.8 million, in the comparable year ago periods, which benefited from the previously mentioned non-cash variable accounting reduction.

Occupancy and equipment expenses amounted to $2.8 million and $5.7 million, decreasing 8.9% from $3.1 million for the quarter ended June 30, 2005 and increasing 2.7% from $5.5 million for the six-month period ended June 30, 2005. The variation is mainly due to the acceleration of leasehold improvements amortization expense due to the relocation in May 2006 of the Group s main offices to a new financial center building, where most non-branch operations have been consolidated for increased efficiencies.

Taxes, other than payroll and income taxes, increased 21.6% to $573,000 from $471,000 for the last quarter and 25.6% to $1.2 million from $934,000 for the six-month period a year ago, mainly due to the increase in revenues and income subject to volume of business tax.

The total decrease in advertising and business promotion, professional and service fees, and electronic banking charges was principally due to effective cost controls.

Table of Contents

TABLE 4 ALLOWANCE FOR LOAN LOSSES SUMMARY
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2006 AND 2005
(Dollars in thousands)

	Quarter Ended June 30, 2006	Quarter Ended June 30, 2005	Change in %	Six-Month Period Ended June 30, 2006	Six-Month Period Ended June 30, 2005	Change in %
Beginning balance	$ 7,160	$ 6,980	2.6%	$ 6,630	$ 7,565	-12.4%
Provision for loan losses	947	850	11.4%	2,048	1,510	35.6%
Net credit losses see Table 5	(606)	(1,335)	-54.6%	(1,177)	(2,580)	-54.4%
Ending balance	**$ 7,501**	**$ 6,495**	**15.5%**	**$ 7,501**	**$ 6,495**	**15.5%**
Selected Data and Ratios:						
Outstanding gross loans at June 30,				$ 1,161,439	$ 910,099	27.6%
Recoveries to charge-offs				18.4%	9.9%	85.9%
Allowance coverage ratio						
Total loans				0.65%	0.71%	-8.5%
Non-performing loans				25.55%	21.05%	21.4%
Non-mortgage non-performing loans				213.52%	139.02%	53.6%

TABLE 5 NET CREDIT LOSSES STATISTICS
(Dollars in thousands)

	Quarter Ended June 30, 2006	Quarter Ended June 30, 2005	Change in %	Six-Month Period Ended June 30, 2006	Six-Month Period Ended June 30, 2005	Change in %
Mortgage						
Charge-offs	$ (178)	$ (911)	-80.5%	$ (377)	$ (1,663)	-77.3%
Recoveries			0.0%			0.0%
	(178)	**(911)**	**-80.5%**	**(377)**	**(1,663)**	**-77.3%**
Commercial						
Charge-offs	(196)	(170)	15.3%	(220)	(485)	-54.6%

Recoveries	76	11	590.9%	83	14	492.9%
	(120)	**(159)**	**-24.5%**	**(137)**	**(471)**	**-70.9%**
Consumer						
Charge-offs	(389)	(378)	2.9%	(845)	(715)	18.2%
Recoveries	81	113	-28.3%	182	269	-32.3%
	(308)	**(265)**	**16.2%**	**(663)**	**(446)**	**48.7%**
Net credit losses						
Total charge-offs	(763)	(1,459)	-47.7%	(1,442)	(2,863)	-49.6%
Total recoveries	157	124	26.6%	265	283	-6.4%
	$ (606)	**$ (1,335)**	**-54.6%**	**$ (1,177)**	**$ (2,580)**	**-54.4%**
Net credit losses to average outstanding (1):						
Mortgage	0.10%	0.58%		0.11%	0.95%	
Commercial	0.22%	0.27%		0.14%	0.53%	
Consumer	3.21%	3.90%		3.56%	3.42%	
Total	**0.25%**	**0.60%**		**0.25%**	**0.61%**	
Average loans:						
Mortgage	$ 714,649	$ 625,556	14.2%	$ 716,601	$ 648,321	10.5%
Commercial	222,574	235,023	-5.3%	194,913	176,474	10.4%
Consumer	38,344	27,146	41.3%	37,295	26,068	43.1%
Total	**$ 975,567**	**$ 887,725**	**9.9%**	**$ 948,809**	**$ 850,863**	**11.5%**

(1) Annualized ratios

Table of Contents

TABLE 6 ALLOWANCE FOR LOSSES BREAKDOWN
(Dollars in thousands)

	June 30, 2006	December 31, 2005	Change in %	June 30, 2005
Allowance for loan losses breakdown:				
Mortgage	$ 3,463	$ 3,185	8.7%	$ 3,167
Commercial	1,721	1,723	-0.1%	1,714
Consumer	2,088	1,417	47.4%	1,335
Unallocated allowance	229	305	-24.9%	279
	$ 7,501	**$ 6,630**	**13.1%**	**$ 6,495**
Allowance composition:				
Mortgage	46.2%	48.0%		48.7%
Commercial	22.9%	26.0%		26.4%
Consumer	27.8%	21.4%		20.6%
Unallocated allowance	3.1%	4.6%		4.3%
	100.0%	**100.0%**		**100.0%**

The provision for loan losses for the quarter and six-month period ended June 30, 2006, totaled $947,000, an 11.4% increase from the $850,000 reported for the same quarter of the previous year, and $2.0 million, an 35.6% increase from the $1.5 million reported for the same six-month period of the previous year. Based on an analysis of the credit quality and composition of its loan portfolio, the Group determined that the provision for the first six months of the current year was adequate in order to maintain the allowance for loan losses at an appropriate level.

Net credit losses for the quarter and six-month period decreased 54.6%, from $1.3 million in the quarter ended June 30, 2005, to $606,000 in the quarter ended June 30, 2006 and 54.4%, from $2.6 million in the six-month period ended June 30, 2005, to $1.2 million in the six-month period ended June 30, 2006. The decreases were primarily due to reductions in net credit losses for mortgage of $729,000 for the quarter and $1.4 million for the six-month period, respectively, when compared to the same periods in the previous year. For the quarter and six-month period of the current year, the net credit losses average ratio was 0.25% for both periods, compared to 0.60% and 0.61%, respectively reported for the same periods of the prior fiscal year. Non-performing loans of $29.4 million as of June 30, 2006 were 4.8% lower than the $30.9 million as of June 30, 2005, and 3.3% higher than the $28.4 million reported as of December 31, 2005 (Table 9).

At June 30, 2006, the Group s allowance for loan losses amounted to $7.5 million (0.65% of total loans) compared to $6.6 million (0.73% of total loans) reported at December 31, 2005. Consumer and mortgage loan allowances increased by 47.4% and 8.7%, or $671,000 and $278,000, respectively, when compared with balances recorded at December 31, 2005. Commercial loans allowance decreased 0.1% or $2,000, when compared to December 31, 2005. Unallocated allowance decreased 25.0%, or $76,000, when compared to December 31, 2005.

The Group maintains an allowance for loan losses at a level that management considers adequate to provide for potential losses based upon an evaluation of known and inherent risks. The Group s allowance for loan losses policy provides for a detailed quarterly analysis of possible losses.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectibility of the loans in light of historical loss experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, the estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The Group uses a methodology that follows a loan credit risk rating process that involves dividing loans into risk categories. The following are the credit risk categories used:

1. **Pass** loans considered highly collectible due to their repayment history or current status.

2. **Special Mention** loans with potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects of the loan.

3. **Substandard** loans inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

-31-

4. **Doubtful** loans that have all the weaknesses inherent in substandard, with the added characteristic that collection or liquidation in full is highly questionable and improbable.

5. **Loss** loans considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

Larger commercial loans that exhibit potential or observed credit weaknesses are subject to individual review and grading. Where appropriate, allowances are allocated to individual loans based on management s estimate of the borrower s ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Group.

Included in the review of individual loans are those that are impaired. A loan is considered impaired when, based on current information and events, it is probable that the Group will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral, if the loan is collateral dependent.

The Group evaluates all loans, some individually and others as homogeneous groups, for purposes of determining impairment. The portfolios of mortgages and consumer loans are considered homogeneous and are evaluated collectively for impairment. For the commercial loans portfolio, all loans over $250,000 are evaluated for impairment. At June 30, 2006, the total investment in impaired loans was $1.8 million, a 50% reduction from the $3.6 million at December 31, 2005, mainly due to certain commercial loans collected during the quarter ended June 30, 2006. Impaired loans are measured based on the fair value of collateral. The Group determined that no specific impairment allowance was required for such loans.

The Group, using an aged-based rating system, applies an overall allowance percentage to each loan portfolio category based on historical credit losses adjusted for current conditions and trends. This delinquency-based calculation is the starting point for management s determination of the required level of the allowance for loan losses. Other data considered in this determination includes:

1. Overall historical loss trends; and
2. Other information including underwriting standards, economic trends and unusual events

Loan loss ratios and credit risk categories are updated quarterly and are applied in the context of GAAP and the Joint Interagency Guidance on the importance of depository institutions having prudent, conservative, but not excessive loan loss allowances that fall within an acceptable range of estimated losses. While management uses available information in estimating possible loan losses, future changes to the allowance may be necessary, based on factors beyond the Group s control, such as factors affecting general economic conditions.

An unallocated allowance is established recognizing the estimation risk associated with the aged-based rating system and with the specific allowances. It is based upon management s evaluation of various conditions, the effects of which are not directly measured in determining the aged-based rating system and the specific allowances. These conditions include then-existing general economic and business conditions affecting our key lending areas; credit quality trends, including trends in non-performing loans expected to result from existing conditions, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, recent loss experience in particular segments of the portfolio, regulatory examination results, and findings by the Group s management. The evaluation of the inherent loss regarding these conditions involves a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments.

Table of Contents

FINANCIAL CONDITION
TABLE 7 ASSETS SUMMARY AND COMPOSITION
(Dollars in thousands)

	June 30, 2006	December 31, 2005	Variance %	June 30, 2005
Investments:				
Mortgage-backed securities	$ 1,993,034	$ 1,961,285	1.6%	$ 1,959,760
U.S. Government and agency obligations	1,258,975	1,251,058	0.6%	1,029,980
P.R. Government and agency obligations	82,474	90,333	-8.7%	108,968
Other investment securities	109,348	90,609	20.7%	66,023
Short-term investments	35,722	63,480	-43.7%	39,791
FHLB stock	18,269	20,002	-8.7%	27,058
	3,497,822	**3,476,767**	**0.6%**	**3,231,580**
	&			