POPULAR INC
Form 10-K
March 15, 2006

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

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

For the Fiscal Year Ended December 31, 2005

OR

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

Commission File No. 0-13818

POPULAR, INC.

Incorporated in the Commonwealth of Puerto Rico
IRS Employer Identification No. 66-0667416
Principal Executive Offices:
209 Muñoz Rivera Avenue
Hato Rey, Puerto Rico 00918
Telephone Number: (787) 765-9800

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: NONE
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Common Stock ($6.00 par value)
Series A Participating Cumulative Preferred Stock Purchase Rights
6.375% Noncumulative Monthly Income Preferred Stock, 2003 Series A
6.70% Cumulative Monthly Income Trust Preferred Securities
6.125% Cumulative Monthly Income Trust Preferred Securities

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

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

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 þ No o.

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

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

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

As of June 30, 2005, the aggregate market value of the common stock held by non-affiliates of the Corporation was $6,724,043,000 based upon the reported closing price of $25.19 on the NASDAQ National Market System on that date.

As of February 28, 2006, there were 278,141,020 shares of the Corporation s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

(1) Portions of the Corporation s Annual Report to Shareholders for the fiscal year ended December 31, 2005 (the Annual Report) are incorporated herein by reference in response to Item 1 of Part I, Items 5 through 8 of Part II and Item 15 (a)(1) of Part IV.

(2) Portions of the Corporation s definitive proxy statement relating to the 2006 Annual Meeting of Stockholders of the Corporation (the Proxy Statement) are incorporated herein by reference in response to Items 10 through 14 of Part III. The Proxy Statement will be filed with the Securities and Exchange Commission (the SEC) on or about March 14, 2006.

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Forward-Looking Statements

Certain statements in this report are forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. These forward-looking statements may relate to the Corporation s financial condition, results of operations, plans, objectives, future performance and business, including, but not limited to, statements with respect to the adequacy of the allowance for loan losses, market risk and the impact of interest rate changes, capital adequacy and liquidity, and the effect of legal proceedings and new accounting standards on the Corporation s financial condition and results of operations. All statements contained herein that are not clearly historical in nature are forward-looking, and the words anticipate, believe, continues, expect, estimate, intend, project and sim expressions and future or conditional verbs such as will, would, should, could, might, can, may, or similar are generally intended to identify forward-looking statements.

These forward-looking statements involve certain risks, uncertainties, estimates and assumptions by management. Various factors, some of which are beyond the Corporation s control, could cause actual results to differ materially from those contemplated by such forward-looking statements. Factors that might cause such a difference include, but are not limited to:

- the rate of growth in the economy, as well as general business and economic conditions;
- changes in interest rates, as well as the magnitude of such changes;
- the fiscal and monetary policies of the federal government and its agencies;
- the relative strength or weakness of the consumer and commercial credit sectors and of the real estate markets;
- the performance of the stock and bond markets;
- competition in the financial services industry;
- possible legislative or regulatory changes; and
- difficulties in combining the operations of acquired entities.

Moreover, the outcome of legal proceedings, as discussed in Part I, Item 3. Legal Proceedings, is inherently uncertain and depends on judicial interpretations of law and the findings of regulators, judges and juries.

All forward-looking statements included in this document are based upon information available to the Corporation as of the date of this document, and we assume no obligation to update or revise any such forward-looking statements.

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PART I
POPULAR, INC.

ITEM 1. BUSINESS

GENERAL

Popular, Inc. (the Corporation) is a diversified, publicly owned bank holding company, registered under the Bank Holding Company Act of 1956, as amended (the BHC Act) and, accordingly, subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the Federal Reserve Board). The Corporation was incorporated in 1984 under the laws of the Commonwealth of Puerto Rico and is the largest financial institution based in Puerto Rico, with consolidated assets of $48.6 billion, total deposits of $22.6 billion and stockholders equity of $3.4 billion at December 31, 2005. At December 31, 2005, the Corporation ranked 25th in assets and 33rd in market value of its common stock among U.S. bank holding companies based on public information gathered and published by SNL Securities.

The Corporation s principal bank subsidiary, Banco Popular de Puerto Rico (Banco Popular or the Bank), was organized in 1893 and is Puerto Rico s largest bank with consolidated total assets of $25.7 billion, deposits of $14.3 billion and stockholder s equity of $1.6 billion at December 31, 2005. The Bank accounted for 53% of the total consolidated assets of the Corporation at December 31, 2005. Banco Popular has the largest retail franchise in Puerto Rico, with 195 branches and over 580 automated teller machines and has the largest trust operation in Puerto Rico. The Bank also operates seven branches in the U.S. Virgin Islands, one branch in the British Virgin Islands and one branch in New York. Banco Popular s deposits are insured under the Bank Insurance Fund (BIF) of the Federal Deposit Insurance Corporation (the FDIC). Banco Popular has three subsidiaries, Popular Auto, Inc., Puerto Rico s largest vehicle financing, leasing and daily rental company, Popular Finance, Inc., a small personal loan and mortgage company with 42 offices and seven mortgage centers in Puerto Rico, and Popular Mortgage, Inc., a mortgage loan company with 33 offices in Puerto Rico.

The Corporation has three other principal subsidiaries: Popular Securities, Inc., Popular International Bank, Inc. (PIB) and EVERTEC, Inc. (formerly GM Group, Inc.). Popular Securities, Inc. is a securities broker-dealer with operations in Puerto Rico and in the mainland United States. Popular Securities, Inc. offers financial advisory, investment and security brokerage services for institutional and retail customers. EVERTEC, Inc. provides electronic data processing and consulting services, sale and rental of electronic data processing equipment, and sale and maintenance of computer software to clients in the United States, the Caribbean and Latin America through offices in Puerto Rico, Venezuela, Miami and the Dominican Republic. At December 31, 2005, EVERTEC, Inc. had total assets of $208 million.

PIB is a wholly owned subsidiary of the Corporation organized in 1992 that operates as an international banking entity under the International Banking Center Regulatory Act of Puerto Rico (the IBC Act). PIB is a registered bank holding company under the BHC Act and is principally engaged in providing managerial services to its subsidiaries.

PIB owns the outstanding stock of Popular North America, Inc. (PNA), ATH Costa Rica, CreST, S.A and Popular Insurance V.I., Inc., an insurance agency. ATH Costa Rica and CreST, S.A. provide ATM switching and driving services in San José, Costa Rica. In addition, PIB has equity investments in Consorcio de Tarjetas Dominicanas (CONTADO), the largest payment network in the Dominican Republic, in Banco Hipotecario Dominicano (BHD) also in the Dominican Republic and in Servicios Financieros, S.A. (Serfinsa), the largest ATM network in El Salvador.

In addition, the Corporation has three other subsidiaries, Popular Life RE, a reinsurance company, Popular Capital Trust I and Popular Capital Trust II, statutory business trusts.

PNA, a wholly owned subsidiary of PIB and an indirect wholly-owned subsidiary of the Corporation, was organized in 1991 under the laws of the State of Delaware and is a registered bank holding company under the BHC Act. PNA functions as a holding company for the Corporation s mainland U.S. operations. As of December 31, 2005, PNA had six direct subsidiaries, all of which were wholly-owned: Banco Popular North America (BPNA), a full service commercial bank incorporated in the state

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of New York; Popular Financial Holdings, Inc., a diversified consumer finance company; Popular Cash Express, Inc., (PCE) a retail financial services company (see recent main developments section below for further information of PCE); BanPonce Trust I and Popular North America Capital Trust I, statutory business trusts; and Banco Popular, National Association (Banco Popular, N.A.), a federally chartered national bank with its main office in Orlando, Florida, which as of December 31, 2005, operated one branch, with assets of $34.4 million and deposits of $13.8 million. Popular Insurance, Inc., a wholly-owned non-bank subsidiary of Banco Popular, N.A. and an indirect subsidiary of PNA, is a general insurance agency that offers insurance products in Puerto Rico. As of December 31, 2005, its assets amounted to $52.1 million.

The banking operations of BPNA in the mainland United States are based in six states. In New York, BPNA operates 32 branches, which accounted for aggregate assets of $2.8 billion and total deposits of $2.6 billion at December 31, 2005. BPNA also operates 19 branches in Illinois and 46 in California with total assets of $2.0 billion and $3.4 billion, respectively, and deposits of $1.7 billion and $1.8 billion, respectively. In addition, BPNA has 14 branches in New Jersey with total assets of $899 million and deposits of $864 million as of December 31, 2005, and 18 branches in Florida with total assets of $1.8 billion and deposits of $1.3 billion. In Texas, BPNA operates seven branches with aggregate assets of $1.1 billion and total deposits of $174 million at the same date. The deposits of BPNA are insured under the BIF by the FDIC.

In addition, BPNA owns all of the outstanding stock of Popular Leasing, USA, a non-banking subsidiary that offers small ticket equipment leasing with 14 offices in 12 states and total assets of $387.3 million as of December 31, 2005. Popular FS, LLC, also a wholly owned subsidiary of BPNA, is engaged in the business of purchasing mortgage loans and its assets totaled $496.7 million at December 31, 2005. Popular Insurance Agency USA, Inc., a wholly owned subsidiary of BPNA, acts as an agent or broker for issuing insurance with total assets of $2.5 million as of December 31, 2005.

Popular Financial Holdings, Inc, is the holding company of Equity One, Inc. Equity One, Inc., is engaged in the business of granting personal and mortgage loans and providing dealer financing through 213 offices in 34 states. Popular Financial Services, LLC, a direct subsidiary of Equity One, Inc., is the wholesale operation which both acquires pools of non-prime loans from mortgage bankers and originates individual mortgage loans through a network of over 2,000 approved mortgage brokers and bankers throughout the U.S. In addition, Popular Warehouse Lending, LLC, a direct subsidiary of Equity One, Inc. provides revolving credit lines ranging from $2 to $15 million to small and mid-size mortgage bankers. Popular Financial Holdings, Inc. had total assets of $9.2 billion as of December 31, 2005.

Recent Main Developments

ACQUISITION OF E-LOAN

In August 2005, the Corporation and E-LOAN, Inc., a California-based online consumer direct lender, announced the signing of a definitive merger agreement under which the Corporation acquired 100% of the issued and outstanding shares of common stock and common stock equivalents of E-LOAN, Inc. for $4.25 per share in cash, or approximately $300 million. This transaction was completed effective November 1, 2005. E-LOAN, Inc., which became a wholly-owned subsidiary of Popular Financial Holdings, Inc., originated over $5 billion in mortgage, home equity, and auto loans in 2004.

ACQUISITION OF ASSETS OF INFINITY MORTGAGE CORPORATION

In September 2005, the Corporation announced a definitive merger agreement to acquire the assets of Infinity Mortgage Corporation, based in New Jersey. Infinity Mortgage Corporation originated over $220 million in mortgage loans during 2004 and operates in New Jersey, New York, Connecticut, Maryland, Massachusetts and Pennsylvania. The transaction was completed on November 11, 2005 and the operations of Infinity Mortgage became part of the mortgage business of Equity One, Inc.

SALE OF ASSETS OF POPULAR CASH EXPRESS

In September 2005, the Corporation announced that ACE Cash Express, Inc. will acquire substantially all of the assets of PCE, the Corporation s wholly-owned check cashing business in the United States. The transaction was completed in the fourth quarter of 2005. As of the end of 2005, PCE continued to operate four offices in the states of Arizona and California.

The Corporation s business is described in more detail on pages 1 through 36 of the Business Review Section of the Annual Report to Shareholders for the year ended December 31, 2005, which is incorporated herein by reference.

REGULATION AND SUPERVISION

General

The Corporation, PIB and PNA are bank holding companies subject to supervision and regulation by the Federal Reserve Board under the BHC Act. Under the BHC Act, prior to the adoption of the Gramm Leach Bliley Act in 1999, the activities of bank holding companies and their banking and non-banking subsidiaries were limited to the business of banking and activities closely related to banking, and no bank holding company could directly or indirectly acquire ownership or control of more than 5% of any class of voting shares or substantially all of the assets of any company in the United States, including a bank, without the prior approval of the Federal Reserve Board. In addition, bank holding companies generally have been prohibited under the BHC Act from engaging in non-banking activities, unless they were found by the Federal Reserve Board to be closely related to banking. The Gramm Leach Bliley Act authorized bank holding companies that qualify as financial holding companies to engage in a substantially broader range of non-banking activities, subject to certain conditions. Effective April 30, 2002, the Corporation elected to be treated as a Financial Holding Company. See Financial Services Modernization below for information regarding changes to these rules.

Banco Popular, BPNA and Banco Popular, N.A. are subject to supervision and examination by applicable federal and state banking agencies including, in the case of Banco Popular, the Federal Reserve Board and the Office of the Commissioner of Financial Institutions of Puerto Rico, in the case of BPNA, the Federal Reserve Board and the New York State Banking Department and in the case of Banco Popular, N.A., the Office of the Comptroller of the Currency (OCC) and the Commissioner of Financial Institutions of Puerto Rico. Banco Popular, BPNA and Banco Popular, N.A. are subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the other types of investments that may be made and the types of services that may be offered. Various consumer laws and regulations also affect the operations of Banco Popular, BPNA and Banco Popular, N.A. See Financial Services Modernization below for information about changes made to these rules. In addition to the impact of regulations, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

Prompt Corrective Action

The Federal Deposit Insurance Act (the FDIA) requires, among other things, the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. The FDIA establishes five capital tiers: well capitalized , adequately capitalized , undercapitalized , significantly undercapitalized , and critically undercapitalized . The relevant capital measures are the total risk-based capital ratio, the Tier 1 risk-based capital ratio and the leverage ratio.

Rules adopted by the federal banking agencies provide that a depository institution will be deemed to be (1) well capitalized if it maintains a leverage ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10% and is not subject to any written agreement or directive to meet a specific capital level; (2) adequately capitalized, if it is not well capitalized, but maintains a leverage ratio of at least 4% (or at least 3% if given the highest regulatory rating and not experiencing or anticipating significant growth), a Tier 1 risk-based capital ratio of at least 4% and a total risk-based capital ratio of at least 8%; (3) undercapitalized if it fails to meet the standards for adequately capitalized institutions (unless it is deemed significantly or critically undercapitalized); (4) significantly undercapitalized if it has a leverage ratio of less than 3%, a Tier 1 risk-based capital ratio of less than 3% or a total risk-based capital ratio of less than 6%; and (5) critically undercapitalized if it has tangible equity equal to 2% or less of total assets.

At December 31, 2005, Banco Popular, BPNA and Banco Popular, N.A. were all well capitalized. An institution s capital category, as determined by applying the prompt corrective action provisions of law, may not constitute an accurate representation of the overall financial condition or prospects of the institution, and the capital condition of the Corporation s banking subsidiaries should be considered in conjunction with other available information regarding the Corporation s financial condition and results of operations.

The appropriate federal banking agency may, under certain circumstances, reclassify a well capitalized insured depository institution as adequately capitalized. The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

The FDIA provides that an institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice.

The FDIA generally prohibits a depository institution from making any capital distribution (including payment of a dividend) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to restrictions on borrowing from the Federal Reserve System. In addition, undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. A depository institution s holding company must guarantee the capital plan, up to an amount equal to the lesser of 5% of the depository institution s assets at the time it becomes undercapitalized or the amount of the capital deficiency when the institution fails to comply with the plan. The federal banking agencies may not accept a capital plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution s capital. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and cessation of receipt of deposits from correspondent banks. Critically undercapitalized depository institutions are subject to appointment of a receiver or conservator.

The capital-based prompt corrective action provisions of the FDIA apply to FDIC-insured depository institutions such as Banco Popular, BPNA and Banco Popular, N.A., but they are not directly applicable to holding companies such as the Corporation, PIB and PNA, which control such institutions. However, the federal banking agencies have indicated that, in regulating holding companies, they may take appropriate action at the holding company level based on their assessment of the effectiveness of supervisory actions imposed upon subsidiary insured depository institutions pursuant to such provisions and regulations.

Holding Company Structure

Banco Popular, BPNA and Banco Popular, N.A. are subject to restrictions under federal law that limit the transfer of funds by any of them to the Corporation, PIB, PNA, or any of the Corporation s other non-banking subsidiaries, whether in the form of loans, other extensions of credit, investments or asset

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purchases. Such transfers by Banco Popular, BPNA and Banco Popular, N.A. to any of the Corporation, PIB, PNA, or any non-banking subsidiaries are limited in amount to 10% of the transferring institution s capital stock and surplus and, with respect to the Corporation and all of its non-banking subsidiaries, to an aggregate of 20% of the transferring institution s capital stock and surplus. For these purposes an institution s capital stock and surplus includes its total risk-based capital plus (1) the balance of its allowance for loan losses not included therein and (2) the amount of certain investments made by the institution in financial subsidiaries that is required to be deducted from the institution s capital for regulatory capital purposes. Furthermore, any such loans and extensions of credit are required to be secured in specified amounts. In addition, federal law requires that any transaction between Banco Popular, BPNA or Banco Popular, N.A., on the one hand, and the Corporation, PIB, PNA or any of the Corporation s other non-banking subsidiaries, on the other hand, be carried out on an arm s length basis.

Under the Federal Reserve Board policy, a bank holding company such as the Corporation, PIB or PNA is expected to act as a source of financial strength to each of its subsidiary banks and to commit resources to support each subsidiary bank. This support may be required at times when, absent such policy, the bank holding company might not otherwise provide such support. In addition, any capital loans by a bank holding company to any of its subsidiary depository institutions are subordinated in right of payment to deposits and to certain other indebtedness of such subsidiary depository institution. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal banking agency to maintain the capital of a subsidiary depository institution will be assumed by the bankruptcy trustee and entitled to a priority of payment. Banco Popular, BPNA and Banco Popular, N.A. are currently the only depository institution subsidiaries of the Corporation, PIB and PNA.

Because the Corporation, PIB and PNA are holding companies, their right to participate in the assets of any subsidiary upon the latter s liquidation or reorganization will be subject to the prior claims of the subsidiary s creditors (including depositors in the case of subsidiary depository institutions) except to the extent that the Corporation, PIB or PNA, as the case may be, may itself be a creditor with recognized claims against the subsidiary.

Under the FDIA, a depository institution, the deposits of which are insured by the FDIC, can be held liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to any commonly controlled FDIC-insured depository institution in danger of default . Default is defined generally as the appointment of a conservator or a receiver, and in danger of default is defined generally as the existence of certain conditions indicating that a default is likely to occur in the absence of regulatory assistance. Banco Popular, BPNA and Banco Popular, N.A. are currently FDIC-insured depository institution subsidiaries of the Corporation and are subject to this cross-guarantee liability. In some circumstances (depending upon the amount of the loss or anticipated loss suffered by the FDIC), cross-guarantee liability may result in the ultimate failure or insolvency of one or more insured depository institutions in a holding company structure. Any obligation or liability owed by a subsidiary depository institution to its parent company is subordinated to the subsidiary depository institution s cross-guarantee liability with respect to commonly controlled FDIC-insured depository institutions.

Dividend Restrictions

The principal source of cash flow for the Corporation is dividends from Banco Popular. Various statutory provisions limit the amount of dividends Banco Popular may pay to the Corporation without regulatory approval. As a member bank subject to the regulation of the Federal Reserve Board, Banco Popular must obtain the approval of the Federal Reserve Board for any dividend, if the total of all dividends declared by the member bank during the calendar year would exceed the total of its net income (as reportable in its Report of Condition and Income) for that year, combined with its retained net income (as defined by regulation) for the preceding two years, less any required transfers to surplus or to a fund for the retirement of any preferred stock. In addition, a member bank may not declare or pay a dividend in an amount greater than its undivided profits as reported in its Report of Condition and Income, unless the member bank has received the approval of the Federal Reserve Board. A member bank also may not permit any portion of its permanent capital to be withdrawn unless the withdrawal has been approved by the

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Federal Reserve Board. For this purpose, permanent capital means the total of the bank s perpetual preferred stock and related surplus, common stock and surplus and minority interests in consolidated subsidiaries, as reportable in the Report of Condition and Income. At December 31, 2005, Banco Popular could have declared a dividend of approximately $231 million without the approval of the Federal Reserve Board.

The payment of dividends by Banco Popular, BPNA and Banco Popular, N.A. may also be affected by other regulatory requirements and policies, such as the maintenance of adequate capital. If, in the opinion of the applicable regulatory authority, a depository institution under its jurisdiction is engaged in, or is about to engage in, an unsafe or unsound practice (that, depending on the financial condition of the depository institution, could include the payment of dividends), such authority may require, after notice and hearing, that such depository institution cease and desist from such practice. In addition, all FDIC-insured depository institutions are subject to the capital-based limitations required by the FDIA. See -Prompt Corrective Action above.

See Puerto Rico Regulation-General below for a description of certain restrictions on Banco Popular s ability to pay dividends under Puerto Rico law.

FDIC Insurance Assessments

Banco Popular, BPNA and Banco Popular, N.A. are subject to FDIC deposit insurance assessments. Pursuant to the FDIA, the FDIC has adopted a risk-based assessment system, under which the assessment rate for an insured depository institution varies according to the level of risk incurred in its activities. An institution s risk category is based partly upon whether the institution is well capitalized, adequately capitalized or less than adequately capitalized. Each FDIC-insured depository institution is currently assigned to one of the following supervisory subgroups : A , B or C . Group A institutions are financially sound institutions with only a few minor weaknesses; Group B institutions are institutions that demonstrate weaknesses that, if not corrected, could result in significant deterioration; and Group C institutions are institutions for which there is a substantial probability that the FDIC will suffer a loss in connection with the institution unless effective action is taken to correct the areas of weakness.

Currently, premiums related to deposits assessed by both the BIF and the Savings Association Insurance Fund (SAIF) are to be assessed at an annual rate of between 0 cents and 27 cents per $100.00 of deposits.

Because of favorable loss experience and a healthy reserve ratio in the BIF, well capitalized and well managed banks, including the Corporation s bank subsidiaries, have in recent years paid no premiums for FDIC insurance.

On February 8, 2006 the President signed the Federal Deposit Insurance Reform Act of 2005 (the Act). The Act provides for the merger of the BIF and SAIF into a single Deposit Insurance Fund, and increase the maximum amount of the insurance coverage for certain retirement accounts, and possible inflation adjustments in the maximum amount of coverage available with respect to other insured accounts. The FDIC is expected to promulgate implementing regulations in the near future, under which, even well capitalized and well managed banks may be required to pay premiums on deposit insurance. It is not possible to determine when any such premiums will become assessable or the level of such premiums.

The Deposit Insurance Funds Act of 1996 also separated the Financing Corporation (FICO) assessment to service the interest on its bond obligations from the BIF and SAIF assessment. The amount assessed on individual institutions by the FICO is in addition to the amount, if any, paid for deposit insurance according to the FDIC s risk-related assessment rate schedules. The current FICO annual assessment rate is 1.32 cents per $100 of deposits. As of December 31, 2005, the Corporation had a BIF deposit assessment base of approximately $21.9 billion.

Brokered Deposits

FDIC regulations adopted under FDIA govern the receipt of brokered deposits. Under these regulations, a bank cannot accept, roll over or renew brokered deposits (which term is defined also to include any deposit with an interest rate more than 75 basis points above prevailing rates) unless it is (i) well capitalized or (ii) adequately capitalized and receives a waiver from the FDIC. A bank that is adequately capitalized may not pay an interest rate on any deposits in excess of 75 basis points over certain prevailing market rates specified by regulation. There are no such restrictions on a bank that is well capitalized. The Corporation does not believe the brokered deposits regulation has had or will have a material effect on the funding or liquidity of Banco Popular, BPNA or Banco Popular, N.A.

Capital Adequacy

Information about the capital composition of the Corporation as of December 31, 2005 and for the four previous years is presented in Table I Capital Adequacy Data on page 28 in the Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

Under the Federal Reserve Board s risk-based capital guidelines for bank holding companies and member banks, the minimum ratio of qualifying total capital (Total Capital) to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit) is 8%. Under the capital guidelines, a banking organization s Total Capital is divided into tiers. Tier 1 Capital consists of common equity, retained earnings, minority interest in equity accounts of consolidated subsidiaries, qualifying non-cumulative perpetual preferred stock and a limited amount of cumulative perpetual preferred stock less goodwill and certain other intangible assets. Not more than 25% of qualifying Tier 1 Capital may consist of noncumulative perpetual preferred stock, trust preferred securities or other so-called restricted core capital elements. Tier 2 Capital consists of, among other things, a limited amount of subordinated debt, other preferred stock, certain other instruments and a limited amount of loan and lease loss reserves. Tier 3 Capital consists of qualifying unsecured subordinated debt. The sum of Tier 2 and Tier 3 Capital may not exceed the amount of Tier 1 Capital.

In addition, the Federal Reserve Board has established minimum leverage ratio guidelines for bank holding companies and member banks. These guidelines provide for a minimum ratio of Tier 1 Capital to total assets, less goodwill and certain other intangible assets discussed below (the leverage ratio) of 3% for bank holding companies and member banks that have the highest regulatory rating or have implemented the Federal Reserve Board s market risk capital measure. All other bank holding companies and member banks are required to maintain a minimum leverage ratio of 4%. The guidelines also provide that banking organizations experiencing internal growth or making acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets. Furthermore, the guidelines indicate that the Federal Reserve Board will continue to consider a tangible Tier 1 leverage ratio and other indicia of capital strength in evaluating proposals for expansion or new activities. The tangible Tier 1 leverage ratio is the ratio of a banking organization s Tier 1 Capital less all intangibles, to total assets less all intangibles.

Banco Popular and BPNA are subject to the risk-based and leverage capital requirements adopted by the Federal Reserve Board. Banco Popular, N.A. is subject to substantially similar requirements of the OCC. See Consolidated Financial Statements, Note 19 Regulatory Capital Requirements on page 92 and 93 for the capital ratios of the Corporation, Banco Popular and BPNA. Failure to meet capital guidelines could subject the Corporation and its depository institution subsidiaries to a variety of enforcement remedies, including the termination of deposit insurance by the FDIC and to certain restrictions on its business. See - Prompt Corrective Action .

The U.S. federal bank regulatory agencies risk-capital guidelines are based upon the 1988 capital accord of the Basel Committee on Banking Supervision (the BSC). The BSC is a committee comprised by central bank governors and bank supervisor authorities of the Group of Ten countries (G10). The BSC is in charge of developing broad policy guidelines used by each country s supervisor to determine its own supervisory guidelines. In January 2001 the BSC released a proposal to replace the 1988 capital accord with a new set of guidelines. The new Basel Accord (Basel II) would set for the first time capital requirements for operational risk and refine the existing capital requirements for credit risk and market risk exposures. The 1988 capital accord does not include a separate capital requirement for operational risk,

which is defined under the proposed accord as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. The federal regulatory agencies are expected to release the latest Notice for Proposed Rulemaking (NPR) and related supervisory guidance by the first quarter of 2006. Under the current timeline, Basel II is expected to be adopted by mandatory and opt-in banks beginning January 2008.

Basel II is still under revision in response to industry, national and regulatory commentaries. Factors such as the capital charge for addressing operational risk are still undergoing changes. In addition, in 2005 federal regulatory banking agencies proposed a revised version of the current capital accord (Basel IA). This proposal is expected to correct material differences between financial institutions adopting Basel II and those institutions remaining under the current regulatory capital regime. The Corporation is closely monitoring the implementation process of these regulatory proposals, and will assess their impact on minimum capital requirements once finalized. The Corporation expects that a new capital accord will eventually be adopted by the BSC and enforced by the federal banking agencies. In the meantime, the Corporation continues to work towards the adoption of a new capital framework, and comply with requirements set by federal regulatory agencies. At this time the Corporation cannot determine with certainty whether the capital requirements that may arise out of a new Basel Accord will increase or decrease minimum capital requirements applicable to the Corporation and its subsidiaries.

In January 2003, the Financial Accounting Standards Board (the FASB) issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), which addresses the consolidation rules to be applied to variable interest entities as defined in FIN 46. In December 2003 the FASB amended FIN 46 in FASB interpretation No. 46 (revised December 2003) (FIN 46R). FIN 46R, applies to certain variable interest entities by no later than March 15, 2004. Under FIN 46R issuer trusts may constitute variable interest entities.

Historically, issuer trusts that issued trust preferred securities have been consolidated by their parent companies and the accounts of such issuer trusts have been included in the consolidated financial statements of such parent companies. In addition, trust preferred securities have been treated as eligible for Tier 1 capital treatment by bank holding companies under Federal Reserve rules and regulations relating to minority interests in equity accounts of consolidated subsidiaries. As of December 31, 2005, $824,000,000 in trust preferred securities that the Corporation treated as Tier 1 capital under existing Federal Reserve Board guidelines were outstanding. The Corporation has determined that the issuer trusts for its trust preferred securities transactions are variable interest entities. The variable interest entities were deconsolidated commencing with the Corporation s December 31, 2003 financial statements.

On March 1, 2005, the Federal Reserve Board adopted a final rule that allows the continued limited inclusion of trust preferred securities in the Tier 1 capital of bank holding companies (BHCs). Under the final rule, trust preferred securities and other restricted core capital elements will be subject to stricter quantitative limits.

The Federal Reserve Board s final rule limits restricted core capital elements to 25 percent of all core capital elements, net of goodwill less any associated deferred tax liability. Internationally active BHCs, defined as those with consolidated assets greater than $250 billion or on-balance-sheet foreign exposure greater than $10 billion, will be subject to a 15 percent limit. They may, however, include qualifying mandatory convertible preferred securities up to the generally applicable 25 percent limit. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The final rule provides a five-year transition period, ending March 31, 2009, for application of the quantitative limits.

Interstate Banking Legislation

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 amended the FDIA to permit a bank holding company, with Federal Reserve Board approval, to acquire banks located in states other than the holding company s home state without regard to whether the transaction is prohibited under state law. In addition, national and state banks with different home states are permitted to merge across state lines, with approval of the appropriate federal banking agency. States are also allowed to permit de novo interstate branching. Once a bank has established branches in a state through an interstate merger transaction, the bank may establish or acquire additional branches at any location in the state where any bank involved in the interstate merger transaction could have established or acquired branches under applicable federal or state law. A bank that has established a branch in a state through de novo branching (if permitted under state laws) may establish and acquire additional branches in such state in the same manner and to the same extent as a bank having a branch in such state as a result of an interstate merger. If a state opted out of interstate branching within the specified time period, no bank in any other state may establish a branch in the state that has opted out, whether through an acquisition or de novo. A foreign bank, like Banco Popular, may establish branches interstate, by merger or de novo, to the same extent as a domestic bank in the foreign bank s home state, which, in the case of Banco Popular, is New York.

Financial Services Modernization

The Gramm-Leach-Bliley Act was enacted on November 12, 1999. Among other things, the Gramm-Leach-Bliley Act: (i) allows bank holding companies whose subsidiary depository institutions meet management, capital and Community Reinvestment Act standards to engage in a substantially broader range of nonbanking activities than was previously permissible, including insurance underwriting and making merchant banking investments in commercial and financial companies; (ii) allows insurers and other financial services companies to acquire banks; (iii) removes various restrictions that previously applied to bank holding company ownership of securities firms and mutual fund advisory companies; and (iv) establishes the overall regulatory structure applicable to bank holding companies that also engage in insurance and securities operations. This part of the Gramm-Leach-Bliley Act became effective on March 11, 2000.

In order for a bank holding company to engage in the broader range of activities that are permitted by the Gramm-Leach-Bliley Act (i) all of its depository institution subsidiaries must be well capitalized (as described above) and well managed and (ii) it must file a declaration with the Federal Reserve that it elects to be a financial holding company. A depository institution is deemed to be well managed if at its most recent inspection, examination or subsequent review by the appropriate federal banking agency (or the appropriate state banking agency), the depository institution received at least a satisfactory composite rating and at least a satisfactory rating for management. In addition, to commence any new activity permitted by the Gramm-Leach-Bliley Act and to acquire any company engaged in any new activities permitted by the Gramm-Leach-Bliley Act, each insured depository institution subsidiary of the financial holding company must have received at least a satisfactory rating in its most recent examination under the Community Reinvestment Act.

The election by the Corporation, PIB and PNA to become financial holding companies became effective April 30, 2002.

The Gramm-Leach-Bliley Act also modified other laws, including laws related to financial privacy and community reinvestment. The new financial privacy provisions generally prohibit financial institutions, including the Corporation s bank subsidiaries, from disclosing nonpublic personal financial information to third parties unless customers have the opportunity to opt out of the disclosure.

Anti-Money Laundering Initiative and the USA PATRIOT Act

On October 26, 2001, the President signed into law comprehensive anti-terrorism legislation known as the USA PATRIOT Act of 2001 (the USA PATRIOT Act). Title III of the USA PATRIOT Act substantially broadened the scope of U.S. anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States.

The U.S. Treasury Department (the Treasury) has issued a number of regulations implementing the USA PATRIOT Act that apply certain of its requirements to financial institutions, including the Corporation s bank subsidiaries. The regulations impose new obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of customers.

Failure of a financial institution to comply with the USA PATRIOT Act s requirements could have serious legal and reputational consequences for the institution. The Corporation believes that the cost of compliance with Title III of the USA PATRIOT Act is not likely to be material to the Corporation.

Community Reinvestment Act

The Community Reinvestment Act requires banks to help serve the credit needs of their communities, including credit to low and moderate income individuals and geographies. Should the Corporation or its bank subsidiaries fail to serve adequately the community, potential penalties may include regulatory denials of applications to expand branches, relocate, add subsidiaries and affiliates, expand into new financial activities and merge with or purchase other financial institutions.

Legislative Initiatives

Various other legislative proposals, including proposals to limit the investments that a depository institution may make with FDIC insured funds, are from time to time introduced in Congress. The Corporation cannot determine the ultimate effect that such potential legislation, if enacted, or implementing regulations would have upon its financial condition or results of operations.

On October 22, 2004, President George W. Bush signed into law the American Jobs Creation Act of 2004, which lowers the withholding tax rate imposed on distributions of U.S. sourced dividends to a corporation organized under the laws of the Commonwealth of Puerto Rico from 30% to 10%. The Corporation s foreign subsidiaries earnings are considered permanently invested. Accordingly, the new law which lowered the withholding tax rate to 10% is not expected to have an impact in the Corporation s earnings in the foreseeable future.

Puerto Rico Regulation

General. As a commercial bank organized under the laws of Puerto Rico, Banco Popular is subject to supervision, examination and regulation by the Office of the Commissioner of Financial Institutions of Puerto Rico (the Office of the Commissioner), pursuant to the Puerto Rico Banking Act of 1933, as amended (the Banking Law).

Section 27 of the Banking Law requires that at least ten percent (10%) of the yearly net income of Banco Popular be credited annually to a reserve fund. This apportionment must be done every year until the reserve fund is equal to the total of paid-in capital on common and preferred stock. At the end of 2005 Banco Popular transferred $31 million to the reserve fund in order to comply with this requirement.

Section 27 of the Banking Law also provides that when the expenditures of a bank are greater than its receipts, the excess of the former over the latter must be charged against the undistributed profits of the bank, and the balance, if any, must be charged against the reserve fund. If the reserve fund is not sufficient to cover such balance in whole or in part, the outstanding amount must be charged against the capital account and no dividend may be declared until capital has been restored to its original amount and the reserve fund to 20% of the original capital.

Section 16 of the Banking Law requires every bank to maintain a legal reserve that, except as otherwise provided by the Office of the Commissioner, may not be less than 20% of its demand liabilities, excluding government deposits (federal, state and municipal) which are secured by collateral. If a bank is authorized to establish one or more bank branches in a state of the United States or in a foreign country, where such branches are subject to the reserve requirements of that state or country, the Office of the Commissioner may exempt said branch or branches from the reserve requirements of Section 16. Pursuant to an order of the Federal Reserve Board dated November 24, 1982, Banco Popular has been exempted from the reserve requirements of the Federal Reserve System with respect to deposits payable in Puerto Rico. Accordingly, Banco Popular is subject to the reserve requirements prescribed by the Banking Law.

Section 17 of the Banking Law permits a bank to make loans to any one person, firm, partnership or corporation, up to an aggregate amount of fifteen percent (15%) of the paid-in capital and reserve fund of the bank. As of December 31, 2005, the legal lending limit for the Bank under this provision was approximately $110.7 million. The above limitations do not apply to loans which are secured by collateral worth at least 25% more than the amount of the loan up to a maximum aggregate amount of one third of the paid-in capital of the bank, plus its reserve fund. If the institution is well capitalized and had been rated 1 in the last examination performed by the Office of the Commissioner or any regulatory agency, its legal lending limit shall also include 15% of 50% of its undivided profits and for loans secured by collateral worth at least 25% more than the amount of the loan, the capital of the bank shall also include 33 1/3% of 50% of its undivided profits. Institutions rated 2 in their last regulatory examination may include this additional component in their legal lending limit only with the previous authorization of the Office of the Commissioner. There are no restrictions under Section 17 on the amount of loans that are wholly secured by bonds, securities and other evidence of indebtedness of the Government of the United States or Puerto Rico, or by current debt bonds, not in default, of municipalities or instrumentalities of Puerto Rico.

Section 14 of the Banking Law authorizes a bank to conduct certain financial and related activities directly or through subsidiaries, including finance leasing of personal property, originating and servicing mortgage loans and operating a small loan company. Banco Popular engages in these activities through its wholly-owned subsidiaries, Popular Auto, Inc., Popular Mortgage, Inc. and Popular Finance, Inc., respectively, all of which are organized and operate in Puerto Rico.

The Finance Board, which includes as its members the Commissioner of Financial Institutions, the Secretary of the Treasury, the Secretary of Commerce, the Secretary of Consumer Affairs, the President of the Planning Board, and the President of the Government Development Bank for Puerto Rico, has the authority to regulate the maximum interest rates and finance charges that may be charged on loans to individuals and unincorporated businesses in Puerto Rico. The current regulations of the Finance Board provide that the applicable interest rate on loans to individuals and unincorporated businesses (including real estate development loans but excluding certain other personal and commercial loans secured by mortgages on real estate properties and finance charges on retail installment sales and for credit card purchases) is to be determined by free competition.

IBC Act. Under the IBC Act, without the prior approval of the Office of the Commissioner, PIB may not amend its articles of incorporation or issue additional shares of capital stock or other securities convertible into additional shares of capital stock unless such shares are issued directly to the shareholders of PIB previously identified in the application to organize the international banking entity, in which case notification to the Office of the Commissioner must be given within ten business days following the date of the issue. Pursuant to the IBC Act, without the prior approval of the Office of the Commissioner, PIB may not initiate the sale, encumbrance, assignment, merger or other transfer of shares if by such transaction a person or persons acting in concert could acquire direct or indirect control of 10% or more of any class of PIB s stock. Such authorization must be requested at least 30 days prior to the transaction.

PIB must submit to the Office of the Commissioner a report of its condition and results of operation on a quarterly basis and its annual audited financial statements at the close of its fiscal year. Under the IBC Act, PIB may not deal with domestic persons as such term is defined in the IBC Act. Also, it may only engage in those activities authorized in the IBC Act, the regulations adopted thereunder and its license.

The IBC Act empowers the Office of the Commissioner to revoke or suspend, after a hearing, the license of an international banking entity (IBE) if, among other things, it fails to comply with the IBC Act, regulations issued by the Office of the Commissioner or the terms of its license or if the Office of the Commissioner finds that the business of the IBE is conducted in a manner not consistent with the public interest.

In January 2004, the Government of Puerto Rico approved a legislation that partially eliminates the tax exempt status of IBE that operates as a division or branch of a bank in Puerto Rico. In order to be subject to tax, the IBE s net taxable income must exceed 40% in 2004, 30% in 2005, and 20% in 2006 and thereafter, of the net taxable income of the bank as a whole. Once these thresholds are exceeded, the IBE will be taxed at regular tax rates on its net taxable income that exceeds the applicable threshold. Currently,

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management of the Corporation does not expect any financial impact from this new legislation since the net taxable income of BPPR s IBE has not exceeded and is not expected to exceed 20% of BPPR s net taxable income.

Employees

At December 31, 2005, the Corporation employed directly 13,210 persons. None of its employees are represented by a collective bargaining group.

Segment Disclosure

Note 30 to the Financial Statements, Segment Reporting on pages 109 through 112 of the Annual Report is herein incorporated by reference.

In connection with the reorganization of the Corporation s corporate structure during 2004, the corporation realigned its business segments to reflect its new business structure, referred to by management as business circles . There is one circle for each of the Corporation s four principal businesses Banco Popular Puerto Rico, Banco Popular North America, Popular Financial Holdings and EVERTEC. Each business circle has been identified as a reportable segment. Also, a corporate circle has been defined to support the business circles.

Management determined the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. The segments were determined based on the new organizational structure which focuses primarily towards products and services as well as on the markets the segments serve. Other factors, such as the credit risk characteristics of the loan products, distribution channels and clientele, were also considered in the determination of reportable segments.

The following table presents the Corporation s long-lived assets by geographical area, other than financial instruments, long-term customer relationships, mortgage and other servicing rights and deferred tax assets. Long-lived assets located in foreign countries represent the investments under the equity method in the Dominican Republic and El Salvador and other long-lived assets located in Costa Rica.

		December 31,	
	2005	2004	2003
Puerto Rico			
Premises and equipment	$472,853,113	$420,204,723	$366,840,357
Goodwill	94,650,541	89,821,933	86,771,141
Other intangible assets	7,149,995	8,975,334	11,489,070
Investments under the equity method	21,434,700	19,711,987	18,046,173
	$596,088,349	$538,713,977	$483,146,741
United States			
Premises and equipment	$119,529,381	$121,121,536	$114,400,824
Goodwill	557,070,780	319,223,720	102,455,795
Other intangible assets	95,390,011	29,458,696	15,355,660
Investments under the equity method	812,183	389,198	376,234
	$772,802,355	$470,193,150	$232,588,513
Foreign Countries			
Premises and equipment	$ 4,188,960	$ 4,355,065	$ 4,211,187
Goodwill	2,262,444	2,262,444	2,262,444

Other intangible assets	-0-	-0-	-0-
Investments under the equity method	40,497,852	36,895,084	20,700,802
	$ 46,949,256	$ 43,512,593	$ 27,174,433

Availability on website

We make available free of charge, through our investor relations section at our website, www.popular.com, our Form 10-K, Form 10-Q and Form 8-K reports and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

The public may read and copy any materials the Corporation files with the SEC at the SEC s Public Reference Room at 100 F Street, N.E., Room 1580, Washington, DC 20549. In addition, the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at its web site (www.sec.gov).

ITEM 1A. RISK FACTORS

Financial results are constantly exposed to market risk.

Market risk refers to the probability of variations in the net interest income or the market value of assets and liabilities due to interest rate volatility. Despite the varied nature of market risks, the primary source of this risk to the Corporation is the impact of changes in interest rates on net interest income.

Net interest income is the difference between the revenue generated on earning assets and the interest cost of funding those assets. Depending on the duration and repricing characteristics of the assets, liabilities and off-balance sheet items, changes in interest rates could either increase or decrease the level of net interest income. For any given period, the pricing structure of the assets and liabilities is matched when an equal amount of such assets and liabilities mature or reprice in that period. Any mismatch of interest-earning assets and interest-bearing liabilities is known as a gap position. A positive gap denotes asset sensitivity, which means that an increase in interest rates could have a positive effect on net interest income, while a decrease in interest rates could have a negative effect on net interest income.

The Corporation is subject to interest rate risk because of the following factors:

- Assets and liabilities may mature or reprice at different times. For example, if assets reprice slower than liabilities and interest rates are generally rising, earnings may initially decline.

- Assets and liabilities may reprice at the same time but by different amounts. For example, when the general level of interest rates is rising, we may increase rates charged on loans by an amount that is less than the general increase in market interest rates because of intense pricing competition. Also, basis risk occurs when assets and liabilities have similar repricing frequencies but are tied to different market interest rate indices.

- Short-term and long-term market interest rates may change by different amounts, *i.e.*, the shape of the yield curve may affect new loan yields and funding costs differently.

- The remaining maturity of various assets and liabilities may shorten or lengthen as interest rates change. For example, if long-term mortgage interest rates decline sharply, mortgage-backed securities held in the securities available-for-sale portfolio may prepay significantly earlier than anticipated, which could reduce portfolio income. If prepayment rates increase, the Corporation would be required to amortize net premiums into income over a shorter period of time, thereby reducing the corresponding asset yield and net interest income. Prepayment risk also has a significant impact on mortgage-backed securities and collateralized mortgage obligations, since prepayments could shorten the weighted average life of these portfolios.

- Interest rates may have an indirect impact on loan demand, credit losses, loan origination volume, the value of securities holdings, including interest-only strips, gains and losses on sales of securities and loans, the value of mortgage servicing rights and other sources of earnings.

In the Corporation s liability sensitive position means that its short-term borrowings and, to a lesser extent, interest-bearing deposits typically reprice faster that the adjustable rate assets. As a result,

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increases in short-term interest rates could reduce net interest income. Also, if the flattening slope of the yield curve and current interest rate conditions persist, coupled with intense pricing competition, the net interest margin could be negatively impacted.

In limiting interest rate risk to an acceptable level, management may alter the mix of floating and fixed rate assets and liabilities, change pricing schedules, adjust maturities through sales and purchases of investment securities, and enter into derivative contracts, among other alternatives. The Corporation may suffer losses or experience lower spreads than anticipated in initial projections as management implement strategies to reduce future interest rate exposure.

The hedging transactions that the Corporation enters into may not be effective in managing the exposure to market risk, including interest rate risk.

The Corporation uses derivatives, to a limited extent, to manage part of the exposure to market risk caused by changes in interest rates or basis risk. The derivative instruments that the Corporation may utilize also have their own risks, which include: (1) basis risk, which is the risk of loss associated with variations in the spread between the asset yield and funding and/or hedge cost; (2) credit or default risk, which is the risk of insolvency or other inability of the counterparty to a particular transaction to perform its obligations thereunder; and (3) legal risk, which is the risk that the Corporation is unable to enforce certain terms of such instruments. All or any of such risks could expose the Corporation to losses.

Reductions in the Corporation s credit ratings or those of any of its subsidiaries would increase the cost of borrowing funds and make the Corporation s ability to raise new funds or renew maturing debt more difficult.

Credit ratings are an important component of the Corporation s liquidity profile. Among other factors, credit ratings are based on the financial strength, the credit quality of and concentrations in the Corporations loan portfolio, the level and volatility of earnings, capital adequacy, the quality of management, the liquidity of the Corporation s balance sheet, the availability of a significant base of core retail and commercial deposits, and the ability to access a broad array of wholesale funding sources. Changes in the Corporation s credit ratings or the credit ratings of any of its subsidiaries to a level below investment grade would adversely affect the Corporation s ability to raise funds in the capital markets. The Corporation s counterparties are also sensitive to the risk of a ratings downgrade. In the event of a downgrade, the cost of borrowing funds would increase. In addition, the Corporation s ability to raise new funds in the capital markets or renew maturing debt may be more difficult.

The Corporation s ability to compete successfully in the marketplace for deposits depends on various factors, including service, convenience and financial stability as reflected by the operating results and credit ratings by nationally recognized credit agencies. A downgrade in credit ratings may impact the ability to raise deposits, but the Corporation believes that the impact should not be material. Deposits at all of its banking subsidiaries are federally insured (subject to limitations established by the Federal Deposit Insurance Corporation), which is expected to mitigate the effect of a downgrade in the credit ratings.

Some of the Corporation s borrowings and deposits are subject to rating triggers , which are contractual provisions that accelerate the maturity of the underlying obligations in the case of a change in the ratings. Therefore, the need to raise funds in the marketplace could increase in the case of a ratings downgrade. As of December 31, 2005, the Corporation had outstanding $216 million of borrowings subject to rating triggers.

A failure to comply with financial covenants in contractual agreements could accelerate payments of related borrowings.

In the course of borrowing from institutional lenders and other investors, the Corporation has entered into contractual agreements to maintain certain levels of debt, capital and asset quality, among other financial covenants. Failing to comply with those agreements may result in an event of default, which could accelerate the repayment of the related borrowings. An event of default would also affect the Corporation s ability to raise new funds or renew maturing debt.

The Corporation is subject to default risk in its loan portfolio.

The Corporation is subject to the risk of loss from loan defaults and foreclosures with respect to the loans originated or acquired. The Corporation establishes provisions for loan losses, which lead to reductions in the income from operations, in order to maintain the allowance for future loan losses at a level which is deemed appropriate by management based upon an assessment of the quality of the loan portfolio in accordance with established procedures and guidelines. There can be no assurance that management has accurately estimated the level of future loan losses or that the Corporation will not have to increase the provision for loan losses in the future as a result of future increases in non-performing loans or for other reasons beyond our control.

A prolonged economic downturn or recession would likely result in an increase in delinquencies, defaults and foreclosures and in a reduction of the loan origination activity which would adversely affect the Corporation s financial results.

A period of reduced economic growth or a recession has historically resulted in a reduction in lending activity and an increase in the rate of defaults in commercial loans, consumer loans and residential mortgages. A recession may have a significant adverse impact on the net interest income and fee income. The Corporation may also experience significant losses on the loan portfolio due to a higher level of defaults on commercial loans, consumer loans and residential mortgages.

The Corporation operates in a highly regulated environment and may be adversely affected by changes in federal and local laws and regulations.

The Corporation is subject to extensive regulation, supervision and examination by federal and Puerto Rico banking authorities. Any change in applicable federal or Puerto Rico laws or regulations could have a substantial impact on its operations. Additional laws and regulations may be enacted or adopted in the future that could significantly affect the Corporation s powers, authority and operations, which could have a material adverse effect on the Corporation s financial condition and results of operations. Further, regulators, in the performance of their supervisory and enforcement duties, have significant discretion and power to prevent or remedy unsafe and unsound practices or violations of laws by banks and bank holding companies. The exercise of this regulatory discretion and power may have a negative impact on the Corporation.

Competition with other financial institutions could adversely affect the Corporation s profitability.

The Corporation faces substantial competition in originating loans and in attracting deposits. The competition in originating loans comes principally from other U.S., Puerto Rico and foreign banks, mortgage banking companies, consumer finance companies, insurance companies and other institutional lenders and purchasers of loans. Certain of the Corporation s competitors are not subject to the same extensive regulation that governs the Corporation s business.

The Corporation anticipates that it will encounter greater competition with the expansion of its operations on the U.S. mainland. Many institutions with which the Corporation competes on the U.S. mainland have significantly greater assets, capital, name recognition, customer loyalty and other resources. As a result, certain of its competitors may have advantages in conducting certain businesses and providing certain services.

Increased competition could require that the Corporation increase the rates offered on deposits or lower the rates charged on loans, which could adversely affect our profitability.

The Corporation is exposed to greater risk because a significant portion of the business is concentrated in Puerto Rico.

A significant portion of the Corporation s financial activities and credit exposure are concentrated in Puerto Rico. Consequently, the financial condition and results of operations are highly dependent on economic conditions in Puerto Rico. An extended economic slowdown in Puerto Rico, adverse political or economic developments in Puerto Rico or natural disasters, such as hurricanes, affecting Puerto Rico could result in a downturn in loan originations, an increase in the level of nonperforming assets, an increase in the

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rate of foreclosure loss on mortgage loans and a reduction in the value of the Corporation s loans and loan servicing portfolio, all of which would adversely affect the Corporation s profitability.

Certain of the provisions contained in the Corporation s Certificate of Incorporation have the effect of making it more difficult to change the Board of Directors, and may make the Board of Directors less responsive to stockholder control.

The Corporation s certificate of incorporation provides that the members of the Board of Directors are divided into three classes as nearly equal as possible. At each annual meeting of stockholders, one-third of the members of the Board of Directors will be elected for a three-year term, and the other directors will remain in office until their three-year terms expire. Therefore, control of the Board of Directors cannot be changed in one year, and at least two annual meetings must be held before a majority of the members of the Board of Directors can be changed. The Corporation s certificate of incorporation also provides that a director, or the entire Board of Directors, may be removed by the stockholders only for cause by a vote of at least two-thirds of the combined voting power of the outstanding capital stock entitled to vote for the election of directors. These provisions have the effect of making it more difficult to change the Board of Directors, and may make the Board of Directors less responsive to stockholder control. These provisions also may tend to discourage attempts by third parties to acquire the Corporation because of the additional time and expense involved and a greater possibility of failure, and, as a result, may adversely affect the price that a potential purchaser would be willing to pay for the capital stock, thereby reducing the amount a stockholder might realize in, for example, a tender offer for the Corporation s capital stock.

Preferred rights issued under the Corporation s Stockholder Protection Rights Agreement may have an anti-takeover effect.

Holders of shares of our common stock are entitled to a preferred right to purchase the Corporation s Series A Participating Cumulative Preferred Stock in certain circumstances. Preferred rights become exercisable if a person or group has acquired 10% or more of the shares of common stock or a tender or exchange offer is commenced which, if consummated, would result in a person becoming the beneficial owner of 10% or more of the common stock. The preferred rights may be deemed to have an anti-takeover effect and generally may cause substantial dilution to a person or group that attempts to acquire the Corporation under circumstances not approved by the Board of Directors.

For further information of other risks faced by the Corporation please refer to the MD&A section of the Annual Report.

The Corporation is unable to predict what adverse consequences, if any, or other effects transactions with Doral Financial Corporation or R&G Financial Corporation, the civil litigation related to Doral or R&G matters or the related investigations could have on the Corporation.

As described in the Annual Report on Form 10-K for the year ended December 31, 2005 under the MD&A Transactions with Doral Financial Corporation and Transactions with R&G Financial Corporation , Doral Financial Corporation (Doral) has announced investigations by the SEC and the U.S. Attorney s Office for the Southern District of New York and R&G Financial Corporation (R&G) has announced an investigation by the Securities and Exchange Commission. The Corporation has had dealings with both Doral and R&G and has provided information in connection with, and is continuing to cooperate with, certain of the investigations of these matters. The Corporation is unable to predict what adverse consequences, if any, or other effects dealings with Doral or R&G, the civil litigation related to Doral or R&G matters or the related investigations could have on the Corporation.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

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