Edgar Filing: POPULAR INC - Form 10-Q
POPULAR INC
Form 10-Q
August 11, 2008

## Table of Contents

## UNITED STATES <br> SECURITIES AND EXCHANGE COMMISSION <br> Washington, D.C. 20549 <br> Form 10-Q

p Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

## For the quarterly period ended June 30, 2008

Commission File Number: 000-13818
POPULAR, INC.
(Exact name of registrant as specified in its charter)

Puerto Rico<br>(State or other jurisdiction of<br>(IRS Employer Identification Number) incorporation or organization)<br>Popular Center Building<br>209 Muñoz Rivera Avenue, Hato Rey<br>San Juan, Puerto Rico 00918<br>(Address of principal executive offices) (Zip code)<br>(787) 765-9800

(Registrant s telephone number, including area code)
NOT APPLICABLE
(Former name, former address and former fiscal year, if changed since last report)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
b Yes o No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer Non-accelerated filer o Smaller reporting company o accelerated filer o p
(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes p No
Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: Common Stock $\$ 6$ par value 281,738,612 shares outstanding as of August 5, 2008.

## POPULAR, INC. INDEX

Page
Part I Financial Information
Item 1. Financial Statements
Unaudited Consolidated Statements of Condition as of June 30, 2008. December 31, 2007 and June 30, 2007 ..... 4
Unaudited Consolidated Statements of Operations for the quarters and six months ended June 30, 2008 and $\underline{2007}$ ..... 5
Unaudited Consolidated Statements of Changes in Stockholders Equity for the six months ended June 30, 2008 and 2007 ..... 6
Unaudited Consolidated Statements of Comprehensive Income for the quarters and six months ended June 30, 2008 and 2007 ..... 7
Unaudited Consolidated Statements of Cash Flows for the six months ended June 30, 2008 and 2007 ..... 8
Notes to Unaudited Consolidated Financial Statements ..... 9
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations ..... 70
Item 3. Quantitative and Qualitative Disclosures about Market Risk ..... 110
Item 4. Controls and Procedures ..... 115
Part II Other Information
Item 1. Legal Proceedings ..... 115
Item 1A. Risk Factors ..... 115
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds ..... 115
Item 4. Submission of Matters to a Vote of Security Holders ..... 116
Item 6. Exhibits ..... 116
Signatures ..... 117EX-12.1 COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES AND PREFERRED STOCK DIVIDENDSEX-31.1 302 CERTIFICATION OF CEO
EX-31.2 302 CERTIFICATION OF CFO
EX-32.1 906 CERTIFICATION OF CEOEX-32.2 906 CERTIFICATION OF CFO

## Table of Contents

## Forward-Looking Information

The information included in this Form 10-Q contains certain forward-looking statements within the meaning of the 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 markets conditions, capital adequacy and liquidity, and the effect of legal proceedings and new accounting standards on the Corporation sfinancial 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 similar expressions and future or conditional verbs such as will, would, could, might, can, may, or similar expressions are generally intended to identify forward-looking statements.
These statements are not guarantees of future performance and involve certain risks, uncertainties, estimates and assumptions by management that are difficult to predict. Various factors, some of which are beyond the Corporation s control, could cause actual results to differ materially from those expressed in, or implied 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, tax or regulatory changes; and difficulties in combining the operations of acquired entities.
Moreover, the outcome of legal proceedings, as discussed in Part II, Item I. 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 to reflect occurrences or unanticipated events or circumstances after the date of such statements.

## Table of Contents

## ITEM 1. FINANCIAL STATEMENTS <br> POPULAR, INC. <br> CONSOLIDATED STATEMENTS OF CONDITION <br> (UNAUDITED)

(In thousands, except share information)
ASSETS
Cash and due from bank

Money market investments:
Federal funds sold
Securities purchased under agreements to resell
Time deposits with other banks

Investment securities available-for-sale, at fair value:
Pledged securities with creditors right to repledge
Other investment securities available-for-sale
Investment securities held-to-maturity, at amortized cost (market value as of June 30, 2008-\$231,210;
December 31, 2007 - \$486,139; June 30, 2007 \$429,536)
Other investment securities, at lower of cost or realizable value (realizable value as of June 30, 2008-\$299,827; December 31, 2007-\$216,819; June 30, 2007 \$160,372)
Trading account securities, at fair value:
Pledged securities with creditors right to repledge
Other trading securities
Loans held-for-sale measured at lower of cost or market value
Loans measured at fair value pursuant to SFAS No. 159: Loans measured at fair value pledged with creditors right to repledge
Other loans measured at fair value
Loans held-in-portfolio:
Loans held-in-portfolio pledged with creditors right to repledge
Other loans
Less Unearned income
Allowance for loan losses
Allowance for loan losses

45,758
799,134
June 30, 2008
\$ 887,619 710,000 170,497 17,299

897,796

3,418,708 4,249,295
4,265,840

484,466
429,479

240,731
417,437
82,051
337,552
December 31, 2007

June 30, 2007

345,400
212,138
17,449
574,987

3,421,716
5,552,752

232,483

216,584
160,150
355,484
321,374
605,990
1,889,546

149,610
195,661
$\begin{array}{rrr}26,636,004 & 28,053,956 & 32,274,058 \\ 186,770 & 182,110 & 323,864\end{array}$
652,730
548,832
564,847
25,796,504
27,472,624
31,581,008

Premises and equipment, net
633,450
588,163
587,505

Edgar Filing: POPULAR INC - Form 10-Q

Other real estate
Accrued income receivable
Servicing assets (at fair value on June 30, 2008 -
\$186,155; December 31, 2007 - \$191,624; June 30, 2007 \$197,873)
Other assets (See Note 8)
Goodwill
Other intangible assets

## LIABILITIES AND STOCKHOLDERS EQUITY

Liabilities:
Deposits:
Non-interest bearing
Interest bearing

Federal funds purchased and assets sold under agreements to repurchase
Other short-term borrowings
Notes payable at cost
Notes payable at fair value pursuant to SFAS No. 159
Other liabilities

| $\$ 4,482,287$ | $\$ 4,510,789$ | $\$ 4,280,195$ |
| ---: | ---: | ---: |
| $22,633,441$ | $23,823,689$ | $21,105,800$ |
|  |  |  |
| $27,115,728$ | $28,334,478$ | $25,385,995$ |
|  |  |  |
| $4,738,677$ | $5,437,265$ | $5,655,936$ |
| $1,337,210$ | $1,501,979$ | $3,384,105$ |
| $3,750,647$ | $4,621,352$ | $8,068,638$ |
| 173,725 |  |  |
| 856,504 | 934,372 | 793,500 |
|  |  |  |
| $37,972,491$ | $40,829,446$ | $43,288,174$ |

Commitments and contingencies (See Note 16)

Minority interest in consolidated subsidiaries
109
109

Stockholders equity:
Preferred stock, $\$ 25$ liquidation value; 30,000,000 shares authorized; 7,475,000 Class A shares issued and outstanding in all periods presented; 16,000,000 Class B shares issued and outstanding at June 30, 2008
Common stock, $\$ 6$ par value; 470,000,000 shares authorized in all periods presented; 294,620,193 shares issued (December 31, 2007-293,651,398; June 30, 2007 - 292,722,761) and 280,983,132 outstanding
(December 31, 2007-280,029,215; June 30, 2007 -
279,326,816)
Surplus
Retained earnings
Accumulated other comprehensive loss, net of tax of (\$22,392) (December 31, 2007 - (\$15,438); June 30, 2007 - (\$96,065))

Treasury stock at cost, $13,637,061$ shares (December 31, 2007-13,622,183; June 30, 2007-13,395,945)
$(207,627)$

3,705,994
3,581,882
3,697,080

$$
\$ 41,678,594 \quad \$ 44,411,437 \quad \$ 46,985,363
$$

The accompanying notes are an integral part of these unaudited consolidated financial statements.

## Table of Contents

## POPULAR, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(In thousands, except per
INTEREST INCOME:
Loans
Money market investments
Investment securities
Trading account securities

INTEREST EXPENSE:
Deposits
Deposits
Short-term borrowings

Long-term debt
Quarter ended
June 30,

20082007
\$497,418
\$656,485
3,476
83,128 113,063
16,133
600,155 784,911

| 168,045 | 182,730 | 362,985 | 355,832 |
| ---: | ---: | ---: | ---: |
| 42,502 | 119,466 | 107,647 | 244,275 |
| 51,723 | 111,298 | 115,392 | 232,000 |
|  |  |  |  |
| 262,270 | 413,494 | 586,024 | 832,107 |
|  |  |  |  |
| 337,885 | 371,417 | 695,074 | 726,399 |
| 190,640 | 115,167 | 358,862 | 211,513 |
|  |  |  |  |
| 147,245 | 256,250 | 336,212 | 514,886 |
| 51,799 | 48,392 | 102,886 | 96,863 |
| 110,079 | 89,590 | 215,546 | 177,439 |

Net gain on sale and valuation adjustments of investment securities
Trading account profit (loss)
Losses from changes in fair value related to instruments measured at fair value pursuant to
SFAS No. 159
$(35,922)$
(Loss) gain on sale of loans and valuation adjustments on loans held-for- sale
Other operating income

| $(35,922)$ |  | $(38,942)$ |  |
| :---: | :---: | :---: | :---: |
|  |  |  |  |
| $(1,453)$ | 28,294 | 67,292 | 31,728 |
| 24,595 | 25,547 | 57,887 | 70,362 |
|  |  |  |  |
| 340,817 | 459,625 | 837,759 | 970,437 |

340,817 459,625
837,759
31,728

| 27,763 | 1,175 | 75,703 | 82,946 |
| ---: | ---: | ---: | ---: |
| 16,711 | 10,377 | 21,175 | $(3,787)$ |

## OPERATING EXPENSES:

Personnel costs:

| Salaries | 125,423 | 126,950 | 262,132 | 263,429 |
| :--- | ---: | ---: | ---: | ---: |
| Pension, profit sharing and other benefits | 36,462 | 37,338 | 74,932 | 79,234 |
|  | 161,885 | 164,288 | 337,064 | 342,663 |
| Net occupancy expenses | 26,362 | 26,501 | 61,354 | 58,515 |
| Equipment expenses | 30,724 | 32,245 | 62,722 | 64,641 |

Edgar Filing: POPULAR INC - Form 10-Q

| Other taxes | 13,879 | 11,835 |  | 27,022 |  | 23,682 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Professional fees | 31,627 | 38,642 |  | 68,252 |  | 74,629 |
| Communications | 13,145 | 16,973 |  | 28,448 |  | 34,035 |
| Business promotion | 18,251 | 30,369 |  | 35,467 |  | 58,741 |
| Printing and supplies | 3,899 | 4,549 |  | 8,174 |  | 8,825 |
| Other operating expenses | 45,471 | 32,838 |  | 86,763 |  | 64,854 |
| Amortization of intangibles | 2,490 | 2,813 |  | 4,982 |  | 5,796 |
|  | 347,733 | 361,053 |  | 720,248 |  | 736,381 |
| (Loss) income before income tax | $(6,916)$ | 98,572 |  | 117,511 |  | 234,056 |
| Income tax (benefit) expense | $(31,166)$ | 23,622 |  | $(10,029)$ |  | 40,459 |
| NET INCOME | \$ 24,250 | \$ 74,950 | \$ | 127,540 | \$ | 193,597 |
| NET INCOME APPLICABLE TO COMMON STOCK | \$ 18,247 | \$ 71,972 | \$ | 118,559 | \$ | 187,641 |
| BASIC EARNINGS PER COMMON SHARE ( EPS ) | \$ 0.06 | \$ 0.26 | \$ | 0.42 | \$ | 0.67 |
| DILUTED EPS | \$ 0.06 | \$ 0.26 | \$ | 0.42 | \$ | 0.67 |
| DIVIDENDS DECLARED PER COMMON SHARE | \$ 0.16 | \$ 0.16 | \$ | 0.32 | \$ | 0.32 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

## Table of Contents

POPULAR, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

| (In thousands) | Six months ended June 30, |  |
| :---: | :---: | :---: |
|  | 2008 | 2007 |
| Preferred stock: |  |  |
| Balance at beginning of year | \$ 186,875 | \$ 186,875 |
| Issuance of preferred stock | 400,000 |  |
| Balance at end of period | 586,875 | 186,875 |
| Common stock: |  |  |
| Balance at beginning of year | 1,761,908 | 1,753,146 |
| Common stock issued under the Dividend Reinvestment Plan | 5,813 | 3,131 |
| Stock options exercised |  | 60 |
| Balance at end of period | 1,767,721 | 1,756,337 |
| Surplus: |  |  |
| Balance at beginning of year | 568,184 | 526,856 |
| Common stock issued under the Dividend Reinvestment Plan | 4,307 | 5,290 |
| Issuance cost of preferred stock | $(9,950)$ |  |
| Stock options expense on unexercised options, net of forfeitures | 559 | 857 |
| Stock options exercised |  | 149 |
| Balance at end of period | 563,100 | 533,152 |
| Retained earnings: |  |  |
| Balance at beginning of year | 1,319,467 | 1,594,144 |
| Net income | 127,540 | 193,597 |
| Cumulative effect of accounting change-adoption of SFAS No. 159 in 2008 |  |  |
| Cash dividends declared on common stock | $(89,822)$ | $(89,352)$ |
| Cash dividends declared on preferred stock | $(8,981)$ | $(5,956)$ |
| Balance at end of period | 1,086,373 | 1,701,100 |
| Accumulated other comprehensive loss: |  |  |
| Balance at beginning of year | $(46,812)$ | $(233,728)$ |
| Other comprehensive loss, net of tax | $(43,636)$ | $(41,089)$ |
| Balance at end of period | $(90,448)$ | $(274,817)$ |
| Treasury stock at cost: |  |  |
| Balance at beginning of year | $(207,740)$ | $(206,987)$ |
| Purchase of common stock | (358) | (352) |
| Reissuance of common stock | 471 | 1,772 |


| Balance at end of period | $(207,627)$ | $(205,567)$ |
| :--- | ---: | ---: |
| Total stockholders equity | $\$ 3,705,994$ | $\$ 3,697,080$ |

## Disclosure of changes in number of shares:

$\left.\begin{array}{lrcr} & \text { June 30, } & \text { December 31, } & \text { June 30, } \\ \text { 2008 }\end{array}\right]$

The accompanying notes are an integral part of these unaudited consolidated financial statements.

## Table of Contents

POPULAR, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME (UNAUDITED)

| (In thousands) | Quarter ended June 30, |  | Six months ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |
| Net income | \$ 24,250 | \$ 74,950 | \$ 127,540 | \$ 193,597 |
| Other comprehensive loss before tax: |  |  |  |  |
| Foreign currency translation adjustment | $(1,411)$ | 1,200 | $(1,192)$ | 2,980 |
| Adjustment of pension and postretirement benefit plans | (37) |  | (74) | (519) |
| Unrealized losses on securities available-for-sale arising during the period | $(149,927)$ | $(95,452)$ | $(22,437)$ | $(55,969)$ |
| Reclassification adjustment for gains included in net income | $(27,685)$ | (1) | $(26,373)$ | (83) |
| Unrealized net gains (losses) on cash flow hedges | 2,963 | 1,840 | $(2,107)$ | 948 |
| Reclassification adjustment for losses (gains) included in net income | 92 | (286) | 1,593 | (125) |
| Cumulative effect of accounting change |  | (243) |  | (243) |
|  | $(176,005)$ | $(92,942)$ | $(50,590)$ | $(53,011)$ |
| Income tax benefit | 41,838 | 22,060 | 6,954 | 11,922 |
| Total other comprehensive loss, net of tax | $(134,167)$ | $(70,882)$ | $(43,636)$ | $(41,089)$ |
| Comprehensive (loss) income | (\$ 109,917) | \$ 4,068 | \$ 83,904 | \$152,508 |

## Tax Effects Allocated to Each Component of Other Comprehensive Loss:

| (In thousands) | Quarter ended June 30, |  | Six months ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |
| Underfunding of pension and postretirement benefit plans |  |  |  | \$ 180 |
| Unrealized losses on securities available-for-sale arising during the period | \$38,943 | \$22,615 | \$3,680 | 12,022 |
| Reclassification adjustment for gains included in net income | 4,025 |  | 3,124 | 14 |
| Unrealized net gains (losses) on cash flows hedges | $(1,094)$ | (669) | 775 | (352) |
| Reclassification adjustment for (gains) losses included in net income | (36) | 114 | (625) | 58 |
| Income tax benefit | \$41,838 | \$22,060 | \$6,954 | \$11,922 |

## Disclosure of accumulated other comprehensive loss:

| (In thousands) | June 30, 2008 | $\begin{gathered} \text { December 31, } \\ 2007 \end{gathered}$ | June 30, 2007 |
| :---: | :---: | :---: | :---: |
| Foreign currency translation adjustment | (\$35,780) | (\$34,588) | (\$ 33,721) |
| Underfunding of pension and postretirement benefit plans | $(51,213)$ | $(51,139)$ | $(69,779)$ |
| Tax effect | 20,108 | 20,108 | 27,214 |
| Net of tax amount | $(31,105)$ | $(31,031)$ | $(42,565)$ |
| Unrealized (losses) gains on securities available-for-sale | $(21,718)$ | 27,092 | $(268,295)$ |
| Tax effect | 854 | $(5,950)$ | 69,182 |
| Net of tax amount | $(20,864)$ | 21,142 | $(199,113)$ |
| Unrealized (losses) gains on cash flows hedges | $(4,129)$ | $(3,615)$ | 913 |
| Tax effect | 1,430 | 1,280 | (331) |
| Net of tax amount | $(2,699)$ | $(2,335)$ | 582 |
| Accumulated other comprehensive loss, net of tax | (\$ 90,448) | (\$46,812) | (\$ 274,817) |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

## Table of Contents

## POPULAR, INC. <br> CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| (In thousands) | Six months ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  | 2008 |  | 2007 |
| Cash flows from operating activities: |  |  |  |  |
| Net income | \$ | 127,540 | \$ | 193,597 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |  |
| Depreciation and amortization of premises and equipment |  | 37,318 |  | 39,973 |
| Provision for loan losses |  | 358,862 |  | 211,513 |
| Amortization of intangibles |  | 4,982 |  | 5,796 |
| Amortization and fair value adjustments of servicing assets |  | 25,122 |  | 22,606 |
| Net gain on sale and valuation adjustments of investment securities |  | $(75,703)$ |  | $(82,946)$ |
| Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 |  | 38,942 |  |  |
| Net gain on disposition of premises and equipment |  | $(3,111)$ |  | $(4,851)$ |
| Net gain on sale of loans and valuation adjustments on loans |  |  |  |  |
| Net amortization of premiums and accretion of discounts on investments |  | 12,656 |  | 11,235 |
| Net amortization of premiums and deferred loan origination fees and |  |  |  |  |
| Earnings from investments under the equity method |  | $(6,899)$ |  | $(16,590)$ |
| Stock options expense |  | 559 |  | 907 |
| Deferred income taxes |  | $(83,836)$ |  | $(48,112)$ |
| Net disbursements on loans held-for-sale |  | $(1,509,819)$ |  | $(3,087,103)$ |
| Acquisitions of loans held-for-sale |  | $(185,053)$ |  | $(403,712)$ |
| Proceeds from sale of loans held-for-sale |  | 1,006,208 |  | 2,833,030 |
| Net decrease in trading securities |  | 732,067 |  | 645,680 |
| Net decrease (increase) in accrued income receivable |  | 42,301 |  | $(1,506)$ |
| Net increase in other assets |  | $(264,170)$ |  | $(16,261)$ |
| Net decrease in interest payable |  | $(53,440)$ |  | $(14,013)$ |
| Net increase in postretirement benefit obligation |  | 203 |  | 1,824 |
| Net decrease in other liabilities |  | $(24,429)$ |  | $(52,071)$ |
| Total adjustments |  | 14,419 |  | 61,609 |
| Net cash provided by operating activities |  | 141,959 |  | 255,206 |
| Cash flows from investing activities: |  |  |  |  |
| Net decrease (increase) in money market investments |  | 108,916 |  | $(206,843)$ |
| Purchases of investment securities: |  |  |  |  |
| Available-for-sale |  | $(3,427,660)$ |  | $(65,385)$ |
| Held-to-maturity |  | $(3,631,141)$ |  | $(12,293,611)$ |
| Other |  | $(136,775)$ |  | $(16,935)$ |
| Proceeds from calls, paydowns, maturities and redemptions of investment securities: |  |  |  |  |


| Available-for-sale | 1,851,899 | 810,710 |
| :---: | :---: | :---: |
| Held-to-maturity | 3,884,838 | 11,957,964 |
| Other | 112,628 | 5,445 |
| Proceeds from sale of investment securities available-for-sale | 2,406,504 | 28,981 |
| Proceeds from sale of other investment securities | 49,330 | 246,352 |
| Net disbursements on loans | $(596,548)$ | $(362,569)$ |
| Proceeds from sale of loans | 1,715,330 | 3,549 |
| Acquisition of loan portfolios | $(6,669)$ | (784) |
| Assets acquired, net of cash |  | $(1,633)$ |
| Mortgage servicing rights purchased | $(2,986)$ | $(23,988)$ |
| Acquisition of premises and equipment | $(98,028)$ | $(49,652)$ |
| Proceeds from sale of premises and equipment | 19,743 | 21,951 |
| Proceeds from sale of foreclosed assets | 51,684 | 80,278 |
| Net cash provided by investing activities | 2,301,065 | 133,830 |
| Cash flows from financing activities: |  |  |
| Net (decrease) increase in deposits | $(1,198,512)$ | 936,810 |
| Net decrease in federal funds purchased and assets sold under agreements to repurchase | $(698,588)$ | $(106,509)$ |
| Net decrease in other short-term borrowings | $(164,769)$ | $(650,020)$ |
| Payments of notes payable | $(1,243,674)$ | $(773,731)$ |
| Proceeds from issuance of notes payable | 630,186 | 103,249 |
| Dividends paid | $(98,685)$ | $(95,223)$ |
| Proceeds from issuance of common stock | 10,120 | 8,667 |
| Proceeds from issuance of preferred stock | 390,050 |  |
| Treasury stock acquired | (358) | (352) |
| Net cash used in financing activities | (2,374,230) | $(577,109)$ |
| Net increase (decrease) in cash and due from banks | 68,794 | $(188,073)$ |
| Cash and due from banks at beginning of period | 818,825 | 950,158 |
| Cash and due from banks at end of period | \$ 887,619 | \$ 762,085 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

## Table of Contents

## Notes to Unaudited Consolidated Financial Statements

## Note 1 Nature of Operations and Basis of Presentation

Popular, Inc. (the Corporation or Popular ) is a diversified, publicly owned financial holding company subject to the supervision and regulation of the Board of Governors of the Federal Reserve System. The Corporation is a full service financial services provider with operations in Puerto Rico, the United States, the Caribbean and Latin America. As the leading financial institution in Puerto Rico, the Corporation offers retail and commercial banking services through its principal banking subsidiary, Banco Popular de Puerto Rico ( BPPR ), as well as auto and equipment leasing and financing, mortgage loans, consumer lending, investment banking, broker-dealer and insurance services through specialized subsidiaries. In the United States, the Corporation operates Banco Popular North America ( BPNA ), including its wholly-owned subsidiary E-LOAN, and Popular Financial Holdings ( PFH ). BPNA is a community bank providing a broad range of financial services and products to the communities it serves. BPNA operates branches in New York, California, Illinois, New Jersey, Florida and Texas. E-LOAN offers online consumer direct lending and provides an online platform to raise deposits for BPNA. As described in Note 19 to the consolidated financial statements, E-LOAN restructured its business operations during the fourth quarter of 2007 and the beginning of 2008. PFH, after certain restructuring events discussed also in Note 19 to the consolidated financial statements, exited the branch network loan origination business during the first quarter of 2008, but continues to operate a mortgage loan servicing unit, a small scale origination / refinancing unit and to carry a maturing loan portfolio. The Corporation, through its transaction processing company, EVERTEC, continues to use its expertise in technology as a competitive advantage in its expansion throughout the United States, the Caribbean and Latin America, as well as internally servicing many of its subsidiaries system infrastructures and transactional processing businesses. Note 24 to the consolidated financial statements presents further information about the Corporation s business segments. The unaudited consolidated financial statements include the accounts of Popular, Inc. and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. These unaudited statements are, in the opinion of management, a fair statement of the results for the periods reported and include all necessary adjustments, all of a normal recurring nature, for a fair statement of such results. Certain reclassifications have been made to the prior period consolidated financial statements to conform to the 2008 presentation.
The statement of condition data as of December 31, 2007 was derived from audited financial statements. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted from the statements presented as of June 30, 2008, December 31, 2007 and June 30, 2007 pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Corporation for the year ended December 31, 2007, included in the Corporation s 2007 Annual Report. The Corporation s Form 10-K filed on February 29, 2008 incorporates by reference the 2007 Annual Report.

## Note 2 Recent Accounting Developments

SFAS No. 157 Fair Value Measurements
SFAS No. 157, issued in September 2006, defines fair value, establishes a framework of measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets carried at fair value will be classified and disclosed in one of the three categories in accordance with the hierarchy. The three levels of the fair value hierarchy are (1) quoted market prices for identical assets or liabilities in active markets, (2) observable market-based inputs or unobservable inputs that are corroborated by market data, and (3) unobservable inputs that are not corroborated by market data. SFAS No. 157 was effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the Financial Accounting Standards Board ( FASB ) issued financial staff position FSP FAS No. 157-2 which defers for one year the effective date for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value on a nonrecurring basis.

## Table of Contents

The staff position also amends SFAS No. 157 to exclude SFAS No. 13 Accounting for Leases and its related interpretive accounting pronouncements that address leasing transactions. The Corporation adopted the provisions of SFAS No. 157 that were not deferred by FSP FAS No. 157-2, commencing in the first quarter of 2008. The provisions of SFAS No. 157 are to be applied prospectively. Refer to Note 12 to these consolidated financial statements for the disclosures required for the quarter and six months ended June 30, 2008. The adoption of SFAS No. 157 in January 1, 2008 did not have an impact in beginning retained earnings.

## SFAS No. 159 The Fair Value Option for Financial Assets and Liabilities Including an Amendment of FASB Statement No. 115

In February 2007, the FASB issued SFAS No. 159, which provided companies with an option to report selected financial assets and liabilities at fair value. The election to measure a financial asset or liability at fair value can be made on an instrument-by-instrument basis and is irrevocable. The difference between the carrying amount and the fair value at the election date is recorded as a transition adjustment to beginning retained earnings. Subsequent changes in fair value are recognized in earnings. The statement also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The Corporation adopted the provisions of SFAS No. 159 in January 2008.
The Corporation elected the fair value option for approximately $\$ 1.2$ billion of whole loans held-in-portfolio by PFH. Additionally, management adopted the fair value option for approximately $\$ 287$ million of loans and $\$ 287$ million of bond certificates associated with PFH s on-balance sheet securitizations that were outstanding as of December 31, 2007. These loans serve as collateral for the bond certificates.

Refer to Note 11 to these consolidated financial statements for the impact of the initial adoption of SFAS No. 159 to beginning retained earnings as of January 1, 2008 and additional disclosures as of June 30, 2008.
FSP FIN No. 39-1 Amendment of FASB Interpretation No. 39
In April 2007, the FASB issued Staff Position FSP FIN No. 39-1, which defines right of setoff and specifies what conditions must be met for a derivative contract to qualify for this right of setoff. It also addresses the applicability of a right of setoff to derivative instruments and clarifies the circumstances in which it is appropriate to offset amounts recognized for those instruments in the statement of condition. In addition, this FSP permits the offsetting of fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments. The adoption of FSP FIN No. 39-1 in January 2008 did not have a material impact on the Corporation s consolidated financial statements and disclosures. The Corporation s policy is not to offset the fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement nor to offset the fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments.
SFAS No. 141-R Statement of Financial Accounting Standards No. 141(R), Business Combinations (a revision of SFAS No. 141)
SFAS No. 141(R), issued in December 2007, will significantly change how entities apply the acquisition method to business combinations. The most significant changes affecting how the Corporation will account for business combinations under this statement include the following: the acquisition date will be the date the acquirer obtains control; all (and only) identifiable assets acquired, liabilities assumed, and noncontrolling interests in the acquiree will be stated at fair value on the acquisition date; assets or liabilities arising from noncontractual contingencies will be measured at their acquisition date at fair value only if it is more likely than not that they meet the definition of an asset or liability on the acquisition date; adjustments subsequently made to the provisional amounts recorded on the acquisition date will be made retroactively during a measurement period not to exceed one year; acquisition-related restructuring costs that do not meet the criteria in SFAS No. 146 Accounting for Costs Associated with Exit or Disposal Activities will be expensed as incurred; transaction costs will be expensed as incurred; reversals of deferred income tax valuation allowances and income tax contingencies will be recognized in earnings subsequent to the
measurement period; and the allowance for loan losses of an acquiree will not be permitted to be recognized by

## Edgar Filing: POPULAR INC - Form 10-Q

## Table of Contents

the acquirer. Additionally, SFAS No. $141(\mathrm{R})$ will require new and modified disclosures surrounding subsequent changes to acquisition-related contingencies, contingent consideration, noncontrolling interests, acquisition-related transaction costs, fair values and cash flows not expected to be collected for acquired loans, and an enhanced goodwill rollforward. The Corporation will be required to prospectively apply SFAS No. 141(R) to all business combinations completed on or after January 1, 2009. Early adoption is not permitted. For business combinations in which the acquisition date was before the effective date, the provisions of SFAS No. 141(R) will apply to the subsequent accounting for deferred income tax valuation allowances and income tax contingencies and will require any changes in those amounts to be recorded in earnings. Management will be evaluating the effects that SFAS No. 141(R) will have on the financial condition, results of operations, liquidity, and the disclosures that will be presented on the consolidated financial statements.
SFAS No. 160 Statement of Financial Accounting Standards No. 160, Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51
In December 2007, the FASB issued SFAS No. 160, which amends ARB No. 51, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 will require entities to classify noncontrolling interests as a component of stockholders equity on the consolidated financial statements and will require subsequent changes in ownership interests in a subsidiary to be accounted for as an equity transaction. Additionally, SFAS No. 160 will require entities to recognize a gain or loss upon the loss of control of a subsidiary and to remeasure any ownership interest retained at fair value on that date. This statement also requires expanded disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective on a prospective basis for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, except for the presentation and disclosure requirements, which are required to be applied retrospectively. Early adoption is not permitted. Management will be evaluating the effects, if any, that the adoption of this statement will have on its consolidated financial statements.

## SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, an amendment of SFAS No. 133. The standard requires enhanced disclosures about derivative instruments and hedged items that are accounted for under SFAS No. 133 and related interpretations. The standard will be effective for all of the Corporation sinterim and annual financial statements for periods beginning after November 15, 2008, with early adoption permitted. The standard expands the disclosure requirements for derivatives and hedged items and has no impact on how the Corporation accounts for these instruments. Management will be evaluating the enhanced disclosure requirements.

## SFAS No. 162 The Hierarchy of Generally Accepted Accounting Principles

SFAS No. 162, issued by the FASB in May 2008, identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. This statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. Management does not expect SFAS No. 162 to have a material impact on the Corporation s consolidated financial statements. The Board does not expect that this statement will result in a change in current accounting practice. However, transition provisions have been provided in the unusual circumstance that the application of the provisions of this statement results in a change in accounting practice.
Staff Accounting Bulletin No. 109 (SAB 109 ) Written Loan Commitments Recorded at Fair Value through Earnings
On November 5, 2007, the SEC issued Staff SAB 109, which requires that the fair value of a written loan commitment that is marked-to-market through earnings should include the future cash flows related to the loan s servicing rights. However, the fair value measurement of a written loan commitment still must exclude the expected net cash flows related to internally developed intangible assets (such as customer relationship intangible assets). SAB 109 applies to two types of loan commitments: (1) written mortgage loan commitments for loans that will be held-for-sale when funded that are marked-to-market as derivatives under SFAS No. 133 (derivative loan commitments); and (2) other
written loan commitments that are accounted for at fair value through earnings under SFAS No. 159 s fair-value election.

## Table of Contents

SAB 109 supersedes SAB 105, which applied only to derivative loan commitments and allowed the expected future cash flows related to the associated servicing of the loan to be recognized only after the servicing asset had been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained. SAB 109 will be applied prospectively to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The implementation of SAB 109 did not have a material impact to the Corporation s consolidated financial statements, including disclosures, for the six months ended June 30, 2008.
FASB Staff Position (FSP) FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions
The objective of FSP FAS 140-3, issued by the FASB in February 2008, is to provide implementation guidance on whether the security transfer and contemporaneous repurchase financing involving the transferred financial asset must be evaluated as one linked transaction or two separate de-linked transactions.
Current practice records the transfer as a sale and the repurchase agreement as a financing. The FSP FAS 140-3 requires the recognition of the transfer and the repurchase agreement as one linked transaction, unless all of the following criteria are met: (1) the initial transfer and the repurchase financing are not contractually contingent on one another; (2) the initial transferor has full recourse upon default, and the repurchase agreement sprice is fixed and not at fair value; (3) the financial asset is readily obtainable in the marketplace and the transfer and repurchase financing are executed at market rates; and (4) the maturity of the repurchase financing is before the maturity of the financial asset. The scope of this FSP is limited to transfers and subsequent repurchase financings that are entered into contemporaneously or in contemplation of one another.
FSP FAS 140-3 will be effective for the Corporation on January 1, 2009. Early adoption is prohibited. The Corporation will be evaluating the potential impact of adopting this FSP.
FASB Staff Position (FSP) FAS 142-3, Determination of the Useful Life of Intangible Assets
FSP FAS 142-3, issued by the FASB in April 2008, amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142 Goodwill and Other Intangible Assets . In developing these assumptions, an entity should consider its own historical experience in renewing or extending similar arrangements adjusted for entity specific factors or, in the absence of that experience, the assumptions that market participants would use about renewals or extensions adjusted for the entity specific factors.
FSP FAS 142-3 shall be applied prospectively to intangible assets acquired after the effective date. This FSP will be effective for the Corporation on January 1, 2009. Early adoption is prohibited. The Corporation will be evaluating the potential impact of adopting this FSP.

## Note 3 Restrictions on Cash and Due from Banks and Highly-Liquid Securities

The Corporation s subsidiary banks are required by federal and state regulatory agencies to maintain average reserve balances with the Federal Reserve Bank or other banks. Those required average reserve balances were $\$ 665$ million as of June 30, 2008 (December 31, $2007 \$ 678$ million; June 30, $2007 \$ 603$ million). Cash and due from banks as well as other short-term, highly-liquid securities are used to cover the required average reserve balances.
In compliance with rules and regulations of the Securities and Exchange Commission, at June 30, 2008, the Corporation had securities with a market value of $\$ 274$ thousand (December 31, 2007 - securities with a market value of $\$ 273$ thousand; June 30, 2007 securities with a market value of $\$ 445$ thousand); segregated in a special reserve bank account for the benefit of brokerage customers of its broker-dealer subsidiary. These securities were classified in the consolidated statement of condition within the other trading securities category.

## Table of Contents

As required by the Puerto Rico International Banking Center Regulatory Act, as of June 30, 2008, December 31, 2007, and June 30, 2007, the Corporation maintained separately for its two international banking entities ( IBEs ), \$600 thousand in time deposits, equally divided for the two IBEs, which were considered restricted assets.
As part of a line of credit facility with a financial institution, as of June 30, 2008, the Corporation maintained restricted cash of $\$ 1.9$ million as collateral (December 31, $2007 \quad \$ 1.9$ million; June 30, $2007 \quad \$ 1.9$ million). The cash is being held in certificates of deposits which mature in less than 90 days. The line of credit is used to support letters of credit.
As of June 30, 2008, the Corporation had restricted cash of $\$ 3.5$ million (December 31, $2007 \$ 3.5$ million) to support a letter of credit related to a service settlement agreement.

## Note 4 Pledged Assets

Certain securities and loans were pledged to secure public and trust deposits, assets sold under agreements to repurchase, other borrowings and credit facilities available. The classification and carrying amount of the Corporation s pledged assets, in which the secured parties are not permitted to sell or repledge the collateral, were as follows:

|  | June 30, <br> (In thousands) | December 31, <br> 2008 | June 30, <br> 2007 |
| :--- | :---: | :---: | ---: |
| Investment securities available-for-sale, at fair value | $\$ 2,716,718$ | $\$ 2,944,643$ | $\$ 3,264,299$ |
| Investment securities held-to-maturity, at amortized <br> cost |  | 339 | 501 |
| Loans held-for-sale measured at lower of cost or <br> market value | 36,613 | 42,428 |  |
| Loans measured at fair value pursuant to SFAS <br> No. 159 | 167,646 |  |  |
| Loans held-in-portfolio | $7,727,951$ | $8,489,814$ | $9,062,900$ |
|  | $\$ 10,648,928$ | $\$ 11,477,224$ | $\$ 12,327,700$ |

Pledged securities and loans in which the creditor has the right by custom or contract to repledge are presented separately in the consolidated statements of condition.
Note 5 Investment Securities Available-For-Sale
The amortized cost, gross unrealized gains and losses and approximate market value (or fair value for certain investment securities where no market quotations are available) of investment securities available-for-sale as of June 30, 2008, December 31, 2007 and June 30, 2007 were as follows:
(In thousands)
U.S. Treasury securities

Obligations of U.S. Government sponsored entities
Obligations of Puerto Rico, States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Equity securities

AS OF JUNE 30, 2008

|  | AS OF JUNE 30, 2008 |  |  |  |
| :--- | :---: | :---: | :---: | :---: |
| Gross |  |  |  |  | | Gross |
| :---: |
| Amortized |
| Unrealized |
| Gains | | Unrealized |
| :---: |
| Losses |$\quad$| Market |
| :---: |
| Value |

Edgar Filing: POPULAR INC - Form 10-Q
Others

| 2,590 |  | 2,590 |  |
| ---: | ---: | ---: | ---: |
| $\$ 7,724,045$ | $\$ 38,133$ | $\$ 59,851$ | $\$ 7,702,327$ |

## Table of Contents

(In thousands)
U.S. Treasury securities
Obligations of U.S. Government sponsored
entities

Obligations of Puerto Rico, States and political subdivisions Collateralized mortgage obligations
Mortgage-backed securities
Equity securities 33,299

Others

| Amortized Cost | AS OF DECEMBER 31, 2007 |  |  |
| :---: | :---: | :---: | :---: |
|  | Gross | Gross |  |
|  | Unrealized Gains | Unrealized Losses | Market Value |
| \$ 476,104 | \$ 3 | \$ 5,011 | 471,096 |
| 5,450,028 | 52,971 | 5,885 | 5,497,114 |
| 103,206 | 470 | 2,184 | 101,492 |
| 1,403,292 | 3,754 | 10,506 | 1,396,540 |
| 1,017,302 | 4,690 | 11,864 | 1,010,128 |
| 33,299 | 690 | 36 | 33,953 |
| 4,812 |  |  | 4,812 |
| \$8,488,043 | \$62,578 | \$35,486 | \$8,515,135 |

(In thousands)
U.S. Treasury securities
Obligations of U.S. Government sponsored entities
Obligations of Puerto Rico, States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Equity securities
Others

| Amortized <br> Cost | Gross <br> Unrealized <br> Gains | Gross <br> Unrealized <br> Losses | Market <br> Value |
| ---: | :---: | ---: | ---: |
| $\$ 500,193$ |  | $\$ 37,616$ | $\$ 462,577$ |
| $6,016,206$ |  | 174,448 | $5,841,758$ |
|  |  |  |  |
| 117,372 | $\$ 170$ | 3,754 | 113,788 |
| $1,544,362$ | 6,122 | 18,435 | $1,532,049$ |
| 991,440 | 1,529 | 32,771 | 960,198 |
| 55,250 | 1,173 | 11,074 | 45,349 |
| 17,940 | 809 |  | 18,749 |
| $\$ 9,242,763$ | $\$ 9,803$ | $\$ 278,098$ | $\$ 8,974,468$ |

\$9,242,763
AS OF JUNE 30, 2007

## Table of Contents

The table below shows the Corporation s amortized cost, gross unrealized losses and market value of investment securities available-for-sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of June 30, 2008, December 31, 2007 and June 30, 2007.
(In thousands)
U.S. Treasury securities
Obligations of U.S. Government sponsored entities

Obligations of Puerto Rico, States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Equity securities

|  |  | 12 months or more <br> Gross |  |
| :--- | ---: | ---: | ---: |
| (In thousands) | Amortized | Unrealized <br> Losses | Market <br> Value |
|  |  |  |  |
| Cbligations of Puerto Rico, States and political subdivisions | $\$ 49,012$ | $\$ 1,724$ | $\$ 47,288$ |
| Collateralized mortgage obligations | 218,656 | 10,453 | 208,203 |
| Mortgage-backed securities | 276,775 | 7,930 | 268,845 |
| Equity securities | 29 | 8 | 21 |
|  | $\$ 544,472$ | $\$ 20,115$ | $\$ 524,357$ |


|  |  | Total <br> Gross |  |  |
| :--- | ---: | ---: | ---: | ---: |
| (In thousands) | Amortized | Unrealized <br> Losses | Market <br> Cost |  |
| Value |  |  |  |  |

## Table of Contents

(In thousands)
Obligations of U.S. Government sponsored entities
Obligations of Puerto Rico, States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Equity securities
(In thousands)
U.S. Treasury securities
Obligations of U.S. Government sponsored entities

Obligations of Puerto Rico, States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Equity securities
(In thousands)
U.S. Treasury securities
Obligations of U.S. Government sponsored entities

Obligations of Puerto Rico, States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Equity securities

AS OF DECEMBER 31, 2007
Less than 12 months
Gross

| Amortized <br> Cost | Unrealized <br> Losses | Market <br> Value |
| :---: | :---: | ---: |
| $\$ 67,107$ | $\$ 185$ | $\$ 66,922$ |
| 2,600 | 2 | 2,598 |
| 349,084 | 2,453 | 346,631 |
| 99,328 | 667 | 98,661 |
| 28 | 10 | 18 |
|  |  |  |
| $\$ 518,147$ | $\$ 3,317$ | $\$ 514,830$ |

12 months or more
Gross

| Amortized | Unrealized | Market |
| :---: | :---: | :---: |
| Cost | Losses | Value |


| $\$ 466,111$ | $\$ 5,011$ | $\$ 461,100$ |
| ---: | ---: | ---: |
| $1,807,457$ | 5,700 | $1,801,757$ |
|  |  |  |
| 65,642 | 2,182 | 63,460 |
| 430,034 | 8,053 | 421,981 |
| 656,879 | 11,197 | 645,682 |
| 300 | 26 | 274 |
|  |  |  |
| $\$ 3,426,423$ | $\$ 32,169$ | $\$ 3,394,254$ |


|  | Total Gross |  |
| :---: | :---: | :---: |
| Amortized | Unrealized | Market |
| Cost | Losses | Value |
| \$ 466,111 | \$ 5,011 | \$ 461,100 |
| 1,874,564 | 5,885 | 1,868,679 |
| 68,242 | 2,184 | 66,058 |
| 779,118 | 10,506 | 768,612 |
| 756,207 | 11,864 | 744,343 |
| 328 | 36 | 292 |
| \$3,944,570 | \$35,486 | \$3,909,084 |

## Table of Contents

\left.|  | AS OF JUNE 30, 2007 |  |  |
| :--- | ---: | ---: | ---: |
| Less than 12 months |  |  |  |
| Gross |  |  |  |$\right]$ Market


|  | 12 months or more <br> Gross |  |  |
| :--- | ---: | ---: | ---: | ---: |
| (In thousands) | Amortized |  |  |
| Cost |  |  |  | | Unrealized |
| :---: |
| Losses |$\quad$| Market |
| :---: |
| Value |


|  | Total <br> Gross |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
| (In thousands) | Amortized <br> Cost | Unrealized <br> Losses | Market <br> Value |  |
| U.S. Treasury securities | $\$ 500,193$ | $\$ 37,616$ | $\$ 462,577$ |  |
| Obligations of U.S. Government sponsored entities | $6,016,206$ | 174,448 | $5,841,758$ |  |
| Obligations of Puerto Rico, States and political |  |  | 3,754 | 87,034 |
| subdivisions | 90,788 | 18,435 | 818,472 |  |
| Collateralized mortgage obligations | 836,907 | 32,771 | 875,704 |  |
| Mortgage-backed securities | 908,475 | 11,074 | 42,919 |  |
| Equity securities | 53,993 |  |  |  |
|  | $\$ 8,406,562$ | $\$ 278,098$ | $\$ 8,128,464$ |  |

As of June 30, 2008, Obligations of Puerto Rico, States and political subdivisions include approximately $\$ 55$ million in Commonwealth of Puerto Rico Appropriation Bonds ( Appropriation Bonds ) in the Corporation s available-for-sale

## Edgar Filing: POPULAR INC - Form 10-Q

and held-to-maturity securities portfolios. The rating on these bonds by Moody s Investors Service ( Moody s ) is Ba1, one notch below investment grade, while Standard \& Poor s ( S\&P ) rates them as investment grade. As of June 30, 2008, these Appropriation Bonds represented approximately $\$ 1.6$ million in net unrealized losses in the Corporation s investment securities available-for-sale portfolio. The Corporation is closely monitoring the political and economic situation of the Island as part of its evaluation of its available-for-sale portfolio for any declines in value that management may consider being other-than-temporary. Management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.
The unrealized loss positions of available-for-sale securities as of June 30, 2008, except for the obligations of the Puerto Rico government described above and certain equity securities which have recently declined in value during 2008, are primarily associated with U.S. Agency and government sponsored-issued mortgage-backed securities and

## Table of Contents

collateralized mortgage obligations. The vast majority of these securities are rated the equivalent of AAA by the major rating agencies. The investment portfolio is structured primarily with highly-liquid securities, which possess a large and efficient secondary market. Management believes that the unrealized losses in these available-for-sale securities as of June 30, 2008 are temporary and are substantially related to market interest rate fluctuations and not to the deterioration in the creditworthiness of the issuers. Also, management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.
During the six months ended June 30, 2008, the Corporation recognized through earnings approximately $\$ 2.9$ million in losses considered other-than-temporary on residual interests classified as available-for-sale. During the six months ended June 30, 2007, the Corporation recognized through earnings approximately $\$ 30.7$ million in losses in residual interests classified as available-for-sale and $\$ 7.6$ million in losses in equity securities that management considered to be other-than-temporarily impaired.
The following table states the names of issuers and the aggregate amortized cost and market value of the securities of such issuer (includes available-for-sale and held-to-maturity securities), when the aggregate amortized cost of such securities exceeds $10 \%$ of stockholders equity. This information excludes securities of the U.S. Government agencies and corporations. Investments in obligations issued by a state of the U.S. and its political subdivisions and agencies, which are payable and secured by the same source of revenue or taxing authority, other than the U.S. Government, are considered securities of a single issuer.

June 30, 2008

| Amortized <br> Cost | Market Value |
| ---: | ---: |
|  |  |
| $\$ 1,137,288$ | $\$ 1,131,842$ |
| $4,506,509$ | $4,521,314$ |
| 816,570 | 810,182 |

December 31, 2007
$\begin{array}{rr}\begin{array}{c}\text { Amortized } \\ \text { Cost }\end{array} & \text { Market Value } \\ & \\ \$ 1,132,834 & \$ 1,128,544 \\ 5,649,729 & 5,693,170 \\ 918,976 & 913,609\end{array}$

June 30, 2007
Amortized
Market Value
\$ 1,261,541 \$ 1,238,499
6,069,496 5,897,748
1,011,125

## Note 6 Investment Securities Held-to-Maturity

The amortized cost, gross unrealized gains and losses and approximate market value (or fair value for certain investment securities where no market quotations are available) of investment securities held-to-maturity as of June 30, 2008, December 31, 2007 and June 30, 2007 were as follows:

|  | AS OF JUNE 30, 2008 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Amortized Cost | Gross Unrealized Gains | Gross <br> Unrealized Losses | Market <br> Value |
| Obligations of U.S. Government sponsored entities | \$ 34,084 |  | \$ 8 | \$ 34,076 |
| Obligations of Puerto Rico, States and political subdivisions | 185,852 | \$280 | 1,566 | 184,566 |
| Collateralized mortgage obligations | 267 |  | 15 | 252 |
| Others | 12,280 | 38 | 2 | 12,316 |
|  | \$232,483 | \$318 | \$ 1,591 | \$231,210 |

## Table of Contents

| (In thousands) | AS OF DECEMBER 31, 2007 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Amortized Cost | Gross Unrealized Gains | Gross <br> Unrealized Losses | Market <br> Value |
| Obligations of U.S. Government sponsored entities | \$395,974 | \$ 15 | \$1,497 | \$394,492 |
| Obligations of Puerto Rico, States and political subdivisions | 76,464 | 3,108 | 26 | 79,546 |
| Collateralized mortgage obligations | 310 |  | 17 | 293 |
| Others | 11,718 | 94 | 4 | 11,808 |
|  | \$484,466 | \$3,217 | \$ 1,544 | \$486,139 |
|  |  | AS OF JUN | E 30, 2007 |  |
| (In thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Market <br> Value |
| Obligations of U.S. Government sponsored entities | \$340,323 | \$ 13 | \$ 36 | \$340,300 |
| Obligations of Puerto Rico, States and political subdivisions | 72,406 | 441 | 374 | 72,473 |
| Collateralized mortgage obligations | 354 |  | 19 | 335 |
| Others | 16,396 | 39 | 7 | 16,428 |
|  | \$429,479 | \$493 | \$436 | \$429,536 |

The following table shows the Corporation s amortized cost, gross unrealized losses and fair value of investment securities held-to-maturity, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of June 30, 2008, December 31, 2007 and June 30, 2007:
(In thousands)
Obligations of U.S. Government sponsored entities
Obligations of Puerto Rico, States and political subdivisions

AS OF JUNE 30, 2008
Less than 12 months
Gross

| Amortized | Unrealized | Market |
| :---: | :---: | :---: |
| Cost | Losses | Value |


| $\$ 34,085$ | $\$$ | 8 |
| ---: | ---: | ---: |
| 41,694 | 1,566 | $\$ 34,077$ |
|  |  | 40,128 |
| $\$ 75,779$ | $\$ 1,574$ | $\$ 74,205$ |

12 months or more
Gross
Amortized Unrealized Market

Edgar Filing: POPULAR INC - Form 10-Q

| (In thousands) | Cost | Losses | Value |
| :--- | ---: | ---: | ---: |
| Collateralized mortgage obligations | $\$ 267$ | $\$ 15$ | $\$ 252$ |
| Others | 1,000 | 2 | 998 |
|  | $\$ 1,267$ | $\$ 17$ | $\$ 1,250$ |

## Table of Contents

|  | Total <br> Gross |  |  |  |
| :--- | :---: | ---: | ---: | ---: |
| (In thousands) | Amortized <br> Cost | Unrealized <br> Losses | Market <br> Value |  |
| Obligations of U.S. Government sponsored entities |  |  |  |  |
| Obligations of Puerto Rico, States and political subdivisions | $\$ 34,085$ | $\$ 1,694$ | 8 | $\$ 34,077$ |
| Collateralized mortgage obligations | 267 | 1,566 | 40,128 |  |
| Others | 1,000 | 15 | 252 |  |
|  |  | 2 | 998 |  |
|  | $\$ 77,046$ | $\$ 1,591$ | $\$ 75,455$ |  |

(In thousands)
Obligations of U.S. Government sponsored entities
Obligations of Puerto Rico, States and political subdivisions
Others
(In thousands)
Collateralized mortgage obligations
Others

| $\$ 310$ | $\$ 17$ | $\$ 293$ |
| ---: | ---: | ---: |
| 1,250 | 3 | 1,247 |
|  |  |  |
| $\$ 1,560$ | $\$ 20$ | $\$ 1,540$ |


| (In thousands) | Amortized <br> Cost | Unrealized <br> Losses | Market <br> Value |
| :--- | ---: | ---: | ---: |
| Obligations of U.S. Government sponsored entities | $\$ 196,129$ | $\$ 1,497$ | $\$ 194,632$ |
| Obligations of Puerto Rico, States and political subdivisions | 1,883 | 26 | 1,857 |
| Collateralized mortgage obligations | 310 | 17 | 293 |
| Others | 2,500 | 4 | 2,496 |
|  | $\$ 200,822$ | $\$ 1,544$ | $\$ 199,278$ |


|  | AS OF JUNE 30, 2007 <br> Less than 12 months Gross |  |  |
| :---: | :---: | :---: | :---: |
| (In thousands) | Amortized Cost | Unrealized Losses | Market <br> Value |
| Obligations of U.S. Government sponsored entities | \$240,336 | \$ 36 | \$240,300 |
| Obligations of Puerto Rico, States and political subdivisions | 20,995 | 223 | 20,772 |
| Others | 250 | 2 | 248 |
|  | \$261,581 | \$261 | \$261,320 |

## Table of Contents

| (In thousands) | 12 months or more Gross |  |  |
| :---: | :---: | :---: | :---: |
|  | Amortized Cost | Unrealized Losses | Market Value |
| Obligations of Puerto Rico, States and political subdivisions | \$24,545 | \$151 | \$24,394 |
| Collateralized mortgage obligations | 354 | 19 | 335 |
| Others | 1,250 | 5 | 1,245 |
|  | \$26,149 | \$175 | \$25,974 |
|  |  | Total Gross |  |
| (In thousands) | Amortized Cost | Unrealized Losses | Market Value |
| Obligations of U.S. Government sponsored entities | \$240,336 | \$ 36 | \$240,300 |
| Obligations of Puerto Rico, States and political subdivisions | 45,540 | 374 | 45,166 |
| Collateralized mortgage obligations | 354 | 19 | 335 |
| Others | 1,500 | 7 | 1,493 |
|  | \$ 287,730 | \$436 | \$287,294 |

Management believes that the unrealized losses in the held-to-maturity portfolio as of June 30, 2008 are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuers. Management has the intent and ability to hold these investments until maturity.

## Note 7 Mortgage Servicing Rights and Residual Interests on Transfers of Mortgage Loans

The Corporation recognizes as assets the rights to service loans for others, whether these rights are purchased or result from asset transfers (sales and securitizations).
Effective January 1, 2007, under SFAS No. 156, the Corporation identified servicing rights related to residential mortgage loans as a class of servicing rights and elected to apply fair value accounting to these mortgage servicing rights ( MSRs ). These MSRs are segregated between loans serviced by PFH and by the Corporation s banking subsidiaries. Fair value determination is performed on a subsidiary basis, with assumptions varying in accordance with the types of assets or markets served.
Classes of mortgage servicing rights were determined based on the different markets or types of assets served. Under the fair value accounting method of SFAS No. 156, purchased MSRs and MSRs resulting from asset transfers are capitalized and carried at fair value.
Effective January 1, 2007, upon the remeasurement of the MSRs at fair value in accordance with SFAS No. 156, the Corporation recorded a cumulative effect adjustment to increase the 2007 beginning balance of MSRs by $\$ 15.3$ million, which resulted in a $\$ 9.6$ million, net of tax, increase in the retained earnings account of stockholders equity in 2007.
At the end of each quarter, the Corporation uses a discounted cash flow model to estimate the fair value of MSRs. The discounted cash flow model incorporates assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, prepayment and late fees, among other considerations. Prepayment speeds are adjusted for the Corporation s loan characteristics and portfolio behavior.

## Table of Contents

The changes in MSRs measured using the fair value method for the six months ended June 30, 2008 and June 30, 2007 were:

| Residential MSRs |  |  |  |
| :---: | :---: | :---: | :---: |
| (In thousands) | Banking subsidiaries | PFH | Total |
| Fair value at January 1, 2008 | \$ 110,612 | \$ 81,012 | \$ 191,624 |
| Purchases | 2,986 |  | 2,986 |
| Servicing from securitizations or asset transfers | 15,521 |  | 15,521 |
| Changes due to payments on loans (1) | $(5,618)$ | $(13,180)$ | $(18,798)$ |
| Changes in fair value due to changes in valuation model inputs or assumptions | 6,390 | $(11,568)$ | $(5,178)$ |
| Fair value as of June 30, 2008 | \$ 129,891 | \$ 56,264 | \$ 186,155 |
| (1) Represents changes due to collection / realization of expected cash flows over time. |  |  |  |


|  | Residential MSRs <br> Banking |  | PFH |
| :--- | :---: | ---: | ---: |

Residential mortgage loans serviced for others were $\$ 20.4$ billion as of June 30, 2008 (December 31, 2007
$\$ 20.5$ billion; June 30, $2007 \quad \$ 15.4$ billion).
Net mortgage servicing fees, a component of other service fees in the consolidated statements of operations, include the changes from period to period in the fair value of the MSRs, which may result from changes in the valuation
model inputs or assumptions (principally reflecting changes in discount rates and prepayment speed assumptions) and other changes, representing changes due to collection / realization of expected cash flows.
The section below includes information on assumptions used in the valuation model of the MSRs, originated and purchased, as well as information on the residual interests derived from securitizations.

## Table of Contents

## Popular Financial Holdings

Key economic assumptions used to estimate the fair value of residual interests and MSRs derived from PFH s securitization transactions and the sensitivity of residual cash flows to immediate changes in those assumptions as of period end were as follows:

| (In thousands) | June 30, 2008 |  |  | December 31, 2007 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Residual Interests | Fixed-rate <br> loans | ARM <br> loans | Residual Interests | Fixed-rate loans |  | ARM <br> loans |
| Carrying amount of retained interests (fair value) | \$37,490 | \$41,109 | \$2,080 | \$45,009 | \$47,243 |  | 1,335 |
| Weighted average life of collateral | 7.8 years | 5.4 years | 3.4 years | 7.6 years | 4.3 years |  | 6 years |
| Weighted average prepayment speed (annual rate) | $\begin{gathered} 16.6 \% \\ \text { (Fixed-rate } \\ \text { loans) } \end{gathered}$ | 16.6\% | 24.0\% | $\begin{gathered} 20.7 \% \\ \text { (Fixed-rate } \\ \text { loans) } \end{gathered}$ | 20.7\% |  | 30.0\% |
| 24.0\% (ARM loans) 30.0\% (ARM lo |  |  |  |  |  |  |  |
| Impact on fair value of $10 \%$ adverse change | \$ 3,428 | (\$723) | \$ 240 | \$ 5,031 | (\$ 192) | \$ | 272 |
| Impact on fair value of $20 \%$ adverse change | \$ 6,820 | (\$ 1,831) | \$ 467 | \$ 6,766 | (\$ 886) | \$ | 688 |
| Weighted average discount rate (annual rate) | 40.0\% | 17.0\% | 17.0\% | 40.0\% | 17.0\% |  | 17.0\% |
| Impact on fair value of $10 \%$ adverse change | (\$ 2,756) | (\$ 1,452) | (\$ 18) | (\$ 2,884) | (\$ 1,466) | (\$ | 225) |
| Impact on fair value of $20 \%$ adverse change | (\$5,159) | (\$ 2,808) | (\$ 36) | (\$ 5,427) | (\$ 2,846) | (\$ | 441) |
|  | $\begin{gathered} 5.62 \% \text { to } \\ 16.29 \% \end{gathered}$ |  |  | $\begin{gathered} 3.35 \% \text { to } \\ 11.03 \% \end{gathered}$ |  |  |  |
| Impact on fair value of $10 \%$ adverse change | (\$7,527) |  |  | (\$ 8,829) |  |  |  |
| Impact on fair value of $20 \%$ adverse change | (\$14,359) |  |  | $(\$ 15,950)$ |  |  |  |

PFH , as servicer, collects prepayment penalties on a substantial portion of the underlying serviced loans. As such, an adverse change in the prepayment assumptions with respect to the MSRs could be partially offset by the benefit derived from the prepayment penalties estimated to be collected.
PFH also owns servicing rights purchased from other institutions. The fair value of purchased MSRs, their related valuation assumptions and the sensitivity to immediate changes in those assumptions as of period end were as follows:

Purchased MSRs
June 30, 2008
December 31, 2007

|  | Fixed-rate <br> loans | ARM loans | Fixed-rate <br> loans | ARM loans |
| :--- | :---: | :---: | :---: | :---: |
| (In thousands) |  |  |  |  |
| Carrying amount of retained interests (fair value) | $\$ 9,416$ | $\$ 3,659$ | $\$ 7,808$ | $\$ 14,626$ |
| Weighted average life of collateral | 6.6 years | 3.5 years | 4.7 years | 3.4 years |
| Weighted average prepayment speed (annual rate) | $14.1 \%$ | $20.6 \%$ | $18.3 \%$ | $25.2 \%$ |


| Impact on fair value of 10\% adverse change | (\$ | 415) | (\$ | 208) | (\$ | 329) | (\$ | 719) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Impact on fair value of $20 \%$ adverse change | (\$ | 817) | (\$ | 402) | (\$ | 631) | (\$ | 1,377) |
| Weighted average discount rate (annual rate) |  | 17.0\% |  | 17.0\% |  | 17.0\% |  | 17.0\% |
| Impact on fair value of $10 \%$ adverse change | (\$ | 522) |  | 136) | (\$ | 330) | (\$ | 509) |
| Impact on fair value of $20 \%$ adverse change | (\$ | 994) | (\$ | 262) | (\$ | 633) | (\$ | 981) |

Another key assumption used to estimate the fair value of PFH s MSRs was the default/delinquency rate which varies by the delinquency bucket in which the particular loans are categorized. The sensitivity to changes in the default curve as of June 30, 2008 was as follows:

|  | Originated MSRs |  | Purchased MSRs |  |
| :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Fixed-rate loans | ARM loans | Fixed-rate loans | ARM loans |
| Fair value | \$41,109 | \$2,080 | \$9,416 | \$3,659 |
| Impact on fair value of $10 \%$ adverse change | (\$ 1,235) | $(\$ 1,408)$ | (\$ 315) | $(\$ 1,978)$ |
| Impact on fair value of $20 \%$ adverse change | (\$ 2,471) | $(\$ 2,795)$ | (\$ 630) | $(\$ 3,935)$ |

## Table of Contents

## Banking subsidiaries

The Corporation s banking subsidiaries retain servicing responsibilities on the sale of wholesale mortgage loans and under pooling / selling arrangements of mortgage loans into mortgage-backed securities, primarily GNMA and FNMA securities. Substantially all mortgage loans securitized by the banking subsidiaries have fixed rates. Under these servicing agreements, the banking subsidiaries do not earn significant prepayment penalty fees on the underlying loans serviced.
Key economic assumptions used in measuring the servicing rights retained at the date of the residential mortgage loan securitizations and whole loan sales by the banking subsidiaries during the quarter ended June 30, 2008 and year ended December 31, 2007 were:

|  | June 30, | December 31, |
| :--- | :---: | ---: |
|  | 2008 | 2007 |
| Prepayment speed | $12.8 \%$ | $9.5 \%$ |
| Weighted average life | 7.8 years | 10.6 years |
| Discount rate (annual rate) | $11.5 \%$ | $10.7 \%$ |

Key economic assumptions used to estimate the fair value of MSRs derived from sales and securitizations of mortgage loans performed by the banking subsidiaries and the sensitivity of residual cash flows to immediate changes in those assumptions were as follows:

Originated MSRs
(In thousands)
June 30, 2008 December 31, 2007

| Fair value of retained interests | \$ 105,235 |  | \$ 86,453 |  |
| :---: | :---: | :---: | :---: | :---: |
| Weighted average life (in years) | 12.4 years |  | 12.5 years |  |
| Weighted average prepayment speed (annual rate) |  | 8.1\% |  | 8.0\% |
| Impact on fair value of $10 \%$ adverse change | (\$ | 4,126) | (\$ | 1,983) |
| Impact on fair value of $20 \%$ adverse change | (\$ | 7,154) | (\$ | 3,902) |
| Weighted average discount rate (annual rate) |  | 11.49\% |  | 10.83\% |
| Impact on fair value of $10 \%$ adverse change | (\$ | 5,524) | (\$ | 2,980) |
| Impact on fair value of $20 \%$ adverse change | (\$ | 9,757) | (\$ | 5,795) |

The banking subsidiaries also own servicing rights purchased from other financial institutions. The fair value of purchased MSRs, their related valuation assumptions and the sensitivity to immediate changes in those assumptions as of period end were as follows:

Purchased MSRs
(In thousands)
June 30, 2008 December 31, 2007
Fair value of retained interests
Weighted average life of collateral
Weighted average prepayment speed (annual rate)
Impact on fair value of $10 \%$ adverse change
Impact on fair value of $20 \%$ adverse change Weighted average discount rate (annual rate) Impact on fair value of $10 \%$ adverse change Impact on fair value of $20 \%$ adverse change

| \$ 24,656 |  | \$ 24,159 |  |
| :---: | :---: | :---: | :---: |
| 12.3 years |  | 12.4 years |  |
|  | 8.2\% |  | 8.0\% |
| (\$ | 1,204) | (\$ | 719) |
| (\$ | 1,943) | (\$ | 1,407) |
|  | 13.1\% |  | 10.8\% |
| (\$ | 1,560) | (\$ | 956) |
| (\$ | 2,597) | (\$ | 1,846) |

The sensitivity analyses presented in the tables above for residual interests and servicing rights of PFH and the banking subsidiaries are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 and 20 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in the sensitivity

## Table of Contents

tables included herein, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.

## Note 8 Other Assets

The caption of other assets in the consolidated statements of condition consists of the following major categories:

| (In thousands) |  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ | $\begin{gathered} \text { December 31, } \\ 2007 \end{gathered}$ |  | June 30, 2007 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net deferred tax assets | \$ | 807,884 | \$ | 525,369 | \$ | 419,611 |
| Trade receivables from brokers and counterparties |  | 515,273 |  | 1,160 |  | 19,685 |
| Securitization advances and related assets |  | 299,519 |  | 168,599 |  | 106,123 |
| Bank-owned life insurance program |  | 219,867 |  | 215,171 |  | 210,333 |
| Prepaid expenses |  | 198,286 |  | 188,237 |  | 200,307 |
| Investments under the equity method |  | 108,008 |  | 89,870 |  | 82,620 |
| Derivative assets |  | 50,121 |  | 76,958 |  | 77,484 |
| Others |  | 256,884 |  | 191,630 |  | 181,437 |
| Total |  | ,455,842 |  | ,456,994 |  | ,297,600 |

## Note 9 Derivative Instruments and Hedging

Refer to Note 30 to the consolidated financial statements included in the 2007 Annual Report for a complete description of the Corporation s derivative activities. The following represents the major changes that occurred in the Corporation s derivative activities during the second quarter of 2008.

## Cash Flow Hedges

Derivative financial instruments designated as cash flow hedges outstanding as of June 30, 2008 and December 31, 2007 were as follows:

| As of June 30, 2008 |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Notional amount | Derivative assets |  | rivative <br> bilities | Equity OCI | Ineffectiveness |
| Asset Hedges |  |  |  |  |  |  |
| Forward commitments | \$ 180,900 | \$ 742 | \$ | 354 | \$ 237 |  |
| Liability Hedges |  |  |  |  |  |  |
| Interest rate swaps | \$ 200,000 |  | \$ | 4,517 | (\$2,936) |  |
| As of December 31, 2007 |  |  |  |  |  |  |
| (In thousands) | Notional amount | Derivative assets |  | rivative <br> bilities | Equity OCI | Ineffectiveness |
| Asset Hedges |  |  |  |  |  |  |
| Forward commitments | \$ 142,700 | \$ 169 | \$ | 509 | (\$ 207) |  |
| Liability Hedges |  |  |  |  |  |  |
| Interest rate swaps | \$ 200,000 |  | \$ | 3,179 | (\$2,066) |  |

The Corporation utilizes forward contracts to hedge the sale of mortgage-backed securities with duration terms over one month. Interest rate forward contracts are contracts for the delayed delivery of securities which the seller agrees to deliver on a specified future date at a specified price or yield. These forward contracts are used to hedge a forecasted transaction and thus qualify for cash flow hedge accounting in accordance with SFAS No. 133, as amended. Changes in the fair value of the derivatives are recorded in other comprehensive income. The amount included in accumulated other comprehensive income corresponding to these forward contracts is expected to be reclassified to earnings in the next twelve months. The contracts outstanding as of June 30, 2008 have a maximum remaining maturity of 84 days.

## Table of Contents

The Corporation also has designated as cash flow hedges, interest rate swap contracts that convert floating rate debt into fixed rate debt by minimizing the exposure to changes in cash flows due to higher interest rates. These interest rate swap contracts have a maximum remaining maturity of 9.3 months.

## Table of Contents

## Non-Hedging Activities

Financial instruments designated as non-hedging derivatives outstanding as of June 30, 2008 and December 31, 2007 were as follows:

As of June 30, 2008

| (In thousands) | Notional amount |  | Fair Values |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  | rivative assets | Derivative liabilities |  |
| Forward contracts | \$ | 379,115 |  | 1,383 | \$ | 987 |
| Interest rate swaps associated with: |  |  |  |  |  |  |
| - bond certificates offered in an on-balance sheet securitization |  | 67,985 |  |  |  | 2,557 |
| - swaps with corporate clients |  | 963,773 |  |  |  | 23,969 |
| - swaps offsetting position of corporate client swaps |  | 963,773 |  | 23,969 |  |  |
| Foreign currency and exchange rate commitments w/ clients |  |  |  |  |  |  |
| Foreign currency and exchange rate commitments w/ counterparty |  | 28 |  |  |  |  |
| Interest rate caps |  | 214,500 |  | 803 |  |  |
| Interest rate caps for benefit of corporate clients |  | 114,500 |  |  |  | 802 |
| Indexed options on deposits |  | 198,307 |  | 21,156 |  |  |
| Indexed options on S\&P Notes |  | 31,152 |  | 2,286 |  |  |
| Bifurcated embedded options |  | 214,766 |  |  |  | 24,784 |
| Mortgage rate lock commitments |  | 98,139 |  | 122 |  | 812 |
| Total |  | ,246,066 |  | 49,719 |  | 53,911 |


| (In thousands) | Notional amount |  | Fair Values |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Derivative assets |  | Derivative liabilities |  |
| Forward contracts | \$ | 693,096 | \$ | 74 | \$ | 3,232 |
| Interest rate swaps associated with: |  |  |  |  |  |  |
| - short-term borrowings |  | 200,000 |  |  |  | 1,129 |
| - bond certificates offered in an on-balance sheet |  | 185,315 |  |  |  | 2.918 |
| - swaps with corporate clients |  | 802,008 |  |  |  | 24,593 |
| - swaps offsetting position of corporate client swaps |  | 802,008 |  | 593 |  |  |
| Credit default swap |  | 33,463 |  |  |  |  |
| Foreign currency and exchange rate commitments w/ clients |  | 146 |  |  |  | 1 |
| Foreign currency and exchange rate commitments w/ counterparty |  | 146 |  | 2 |  |  |
| Interest rate caps |  | 150,000 |  | 27 |  |  |
| Interest rate caps for benefit of corporate clients |  | 50,000 |  |  |  | 18 |
| Indexed options on deposits |  | 211,267 |  | , 954 |  |  |

Edgar Filing: POPULAR INC - Form 10-Q

| Indexed options on S\&P Notes | 31,152 | 5,962 |  |
| :--- | ---: | ---: | ---: |
| Bifurcated embedded options | 218,327 |  | 50,227 |
| Mortgage rate lock commitments | 148,501 | 258 | 386 |
|  |  |  |  |
| Total | $\$ 3,525,429$ | $\$ 76,870$ | $\$ 82,504$ |

## Interest Rates Swaps

The Corporation has an interest rate swap outstanding with a notional amount of $\$ 68$ million to economically hedge the payments of certificates issued as part of a securitization. This swap is marked-to-market quarterly and recognized as part of interest expense. The Corporation recognized gains of $\$ 2.4$ million for the second quarter and $\$ 0.4$ million for the six months ended June 30, 2008 due to changes in the fair value of this swap. The Corporation recognized gains of $\$ 1.7$ million for the second quarter and $\$ 1.9$ million for the six months ended June 30, 2007 due to changes in its fair value.
In addition, the Corporation also utilizes interest rate swaps in its capacity as an intermediary on behalf of its customers. The Corporation minimizes its market risk and credit risk by taking offsetting positions under the same terms and conditions with credit limit approvals and monitoring procedures.
Interest Rate Caps

## Table of Contents

The Corporation has interest rate caps to economically hedge the exposure to rising interest rates of certain short-term borrowings. Additionally, the Corporation enters into interest rate caps as an intermediary on behalf of its customers and simultaneously takes offsetting positions with creditworthy counterparts under the same terms and conditions thus minimizing its market and credit risks.

## Forward Contracts

The Corporation has loan sales commitments to economically hedge the changes in fair value of mortgage loans held-for-sale associated with interest rate lock commitments through both mandatory and best efforts forward sales agreements. These contracts are entered into in order to optimize the gain on sales of loans. These contracts are recognized at fair market value with changes directly reported in income as part of gain on sale of loans. For the quarter and six months ended June 30,2008 , gains of $\$ 1.1$ million and $\$ 2.2$ million, respectively, were recognized due to changes in fair value of these forward sales commitments. For the quarter and six months ended June 30, 2007, gains of $\$ 2.3$ million and $\$ 1.6$ million, respectively, were recognized due to changes in fair value of these forward sales commitments. Additionally, the Corporation has forward commitments to hedge the changes in fair value of certain MBS securities classified as trading securities. For the quarter and six months ended June 30, 2008, the Corporation recognized gains of $\$ 611$ thousand and $\$ 1.4$ million, respectively, due to changes in the fair value of these forward commitments, which were recognized as part of trading gains and losses. For the quarter and six months ended June 30, 2007, gains of $\$ 428$ thousand and $\$ 259$ thousand, respectively, were recognized due to changes in fair value of these forward commitments.

## Mortgage Rate Lock Commitments

The Corporation has mortgage rate lock commitments to fund mortgage loans at interest rates previously agreed for a specified period of time. The mortgage rate lock commitments are accounted as derivatives pursuant to SFAS No. 133. These contracts are recognized at fair value with changes directly reported in income as part of gain on sale of loans. For the quarter and six months ended June 30, 2008, losses of $\$ 639$ thousand and $\$ 562$ thousand, respectively, were recognized due to changes in fair value of these commitments. For the quarter and six months ended June 30, 2007, the Corporation recognized losses of $\$ 2.3$ million and $\$ 1.5$ million, respectively, related to these commitments.

## Note 10 Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the six months ended June 30, 2008 and 2007, allocated by reportable segments, were as follows (refer to Note 24 for the definition of the Corporation s reportable segments):

| 2008 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Balance at January 1, 2008 | Goodwill acquired | Purchase accounting adjustments | Other | Balance at June 30, 2008 |
| Banco Popular de Puerto Rico: |  |  |  |  |  |
| Commercial Banking | \$ 35,371 |  | (\$ 115) |  | \$ 35,256 |
| Consumer and Retail Banking | 136,407 |  | (562) |  | 135,845 |
| Other Financial Services | 8,621 | \$ 153 |  | \$ | 8,777 |
| Banco Popular North America: |  |  |  |  |  |
| Banco Popular North America | 404,237 |  |  |  | 404,237 |
| E-LOAN |  |  |  |  |  |
| Popular Financial Holdings |  |  |  |  |  |
| EVERTEC | 46,125 | 1,000 |  | $(2,414)$ | 44,711 |
| Total Popular, Inc. | \$ 630,761 | \$1,153 | (\$ 677) | (\$ 2,411) | \$628,826 |

## Table of Contents

|  | 2007 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Balance at <br> January 1, 2007 | Goodwill acquired | Other | Balance at June 30, 200 |
| Banco Popular de Puerto Rico: |  |  |  |  |
| Commercial Banking | \$ 14,674 |  |  | \$ 14,674 |
| Consumer and Retail Banking | 34,999 |  |  | 34,999 |
| Other Financial Services | 4,391 | \$ 24 |  | 4,415 |
| Banco Popular North America: |  |  |  |  |
| Banco Popular North America | 404,237 |  |  | 404,237 |
| E-LOAN | 164,410 |  |  | 164,410 |
| Popular Financial Holdings |  |  |  |  |
| EVERTEC | 45,142 | 775 | (\$183) | 45,734 |
| Total Popular, Inc. | \$ 667,853 | \$799 | (\$183) | \$668,469 |

Purchase accounting adjustments consist of adjustments to the value of the assets acquired and liabilities assumed resulting from the completion of appraisals or other valuations, adjustments to initial estimates recorded for transaction costs, if any, and contingent consideration paid during a contractual contingency period. The purchase accounting adjustments during the six months ended June 30, 2008 at the BPPR reportable segment were mostly related to the acquisition of Citibank s retail branches in Puerto Rico (acquisition completed in December 2007). The reduction in goodwill in the EVERTEC reportable segment during the six months ended June 30, 2008 was the result of the sale of substantially all assets of EVERTEC s health processing division during the second quarter of 2008. As of June 30, 2008, other than goodwill, the Corporation had $\$ 17$ million of identifiable intangibles with indefinite useful lives (December 31, $2007 \$ 17$ million; June 30, $2007 \quad \$ 65$ million).
The following table reflects the components of other intangible assets subject to amortization:

|  | June 30, 2008 |  | December 31, 2007 |  | June 30, 2007 |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Gross | Accumulated | Gross | Accumulated |  |  |  |
| Amortization |  |  |  |  |  |  | | Amount | Amortization | Amount |
| :---: | :---: | :---: | :---: | :---: | :---: | | Accumulated |
| :---: |
| Amortization |

Certain core deposit intangibles with a gross amount of $\$ 699$ thousand became fully amortized or written off during the six months ended June 30, 2008 and, as such, their gross amount and accumulated amortization were eliminated from the tabular disclosure presented above.
During the quarter and six months ended June 30, 2008, the Corporation recognized $\$ 2.5$ million and $\$ 5.0$ million, respectively, in amortization expense related to other intangible assets with definite lives (June 30, 2007-\$2.8 million and $\$ 5.8$ million in the quarter and six months ended June 30, 2007, respectively).

## Table of Contents

The following table presents the estimated aggregate annual amortization expense of the intangible assets with definite lives for each of the following fiscal years:

|  | (In |
| :---: | :---: |
|  | (In |
| 2008 | $\$ 4,717$ |
| 2009 | 8,332 |
| 2010 | 7,479 |
| 2011 | 6,125 |
| 2012 | 5,105 |

No significant events or circumstances have occurred during the quarter ended June 30, 2008 that would reduce the fair value of any reporting unit below its carrying amount.

## Note 11 Fair Value Option

As indicated in Note 2 to the consolidated financial statements, the Corporation elected to measure at fair value certain loans and borrowings outstanding at January 1, 2008 pursuant to the fair value option provided by SFAS No. 159. These financial instruments, all of which pertained to the operations of Popular Financial Holdings that are running off, were as follows:

Approximately $\$ 1.2$ billion of whole loans held-in-portfolio by PFH that were outstanding as of December 31, 2007. These whole loans consist principally of first lien residential mortgage loans and closed-end second lien loans that were originated through the exited origination channels of PFH (e.g. asset acquisition, broker and retail channels), and home equity lines of credit that had been originated by E-LOAN, but sold to PFH as part of the Corporation s 2007 U.S. reorganization whereby E-LOAN became a subsidiary of BPNA. Also, to a lesser extent, the loan portfolio included mixed-use / multi-family loans (small commercial category) and manufactured housing loans.

Management believes that accounting for these loans at fair value provides a more relevant and transparent measurement of the realizable value of the assets and differentiates the PFH portfolio from the loan portfolios that the Corporation will continue to originate through channels other than PFH.

Approximately $\$ 287$ million of owned-in-trust loans and $\$ 287$ million of bond certificates associated with PFH securitization activities that were outstanding as of December 31, 2007. The owned-in-trust loans are pledged as collateral for the bond certificates as a financing vehicle through on-balance sheet securitization transactions. These loan securitizations conducted by the Corporation did not meet the sale criteria under SFAS No. 140; accordingly, the transactions are treated as on-balance sheet securitizations for accounting purposes. Due to the terms of the transactions, particularly the existence of an interest rate swap agreement and to a lesser extent clean up calls, the Corporation was unable to recharacterize these loan securitizations as sales for accounting purposes in 2007. The owned-in-trust loans include first lien residential mortgage loans, closed-end second lien loans, mixed-use / multi-family loans (small commercial category) and manufactured housing loans. The majority of the portfolio is comprised of first lien residential mortgage loans.

These owned-in-trust loans do not pose the same magnitude of risk to the Corporation as those loans owned outright because certain of the potential losses related to owned-in-trust loans are born by the bondholders and not the Corporation. Upon the adoption of SFAS No. 159, the loans and related bonds are both measured at fair value, thus their net position better portrays the credit risk born by the Corporation.
Excluding the PFH loans elected for the fair value option as described above, PFH s reportable segment held approximately $\$ 1.8$ billion of additional loans at the time of fair value option election on January 1, 2008. Of these remaining loans, $\$ 1.4$ billion were classified as loans held-for-sale and were not subject to the fair value option as the loans were intended to be sold to an institutional buyer during the first quarter of 2008. These loans were sold in March 2008. The remaining $\$ 0.4$ billion in other loans held-in-portfolio at PFH as of that same date consisted
principally of a small portfolio of auto loans that was acquired from E-LOAN, warehousing revolving lines of credit

## Table of Contents

with monthly advances and pay-downs, and construction credit agreements in which permanent financing will be with a lender other than PFH. Although these businesses are running off, PFH must contractually continue to fund the revolving credit arrangements.
There were no other assets or liabilities elected for the fair value option after January 1, 2008.
Upon adoption of SFAS No. 159 the Corporation recognized a $\$ 262$ million negative after-tax adjustment ( $\$ 409$ million before tax) to beginning retained earnings due to the transitional adjustment for electing the fair value option, as detailed in the following table.

|  |  | Cumulative effect |  |
| :---: | :---: | :---: | :---: |
| (In thousands) | January 1, 2008 (Carrying value <br> prior to adoption) | adjustment to <br> January 1, 2008 retained earningsGain (Loss) | January 1, 2008 fair value (Carrying value after adoption) |
| Loans | \$ 1,481,297 | (\$ 494,180) | \$ 987,117 |
| Notes payable (bond certificates) | (\$ 286,611) | \$ 85,625 | (\$ 200,986) |

Pre-tax cumulative effect of adopting fair value option accounting
(\$ 408,555)
Net increase in deferred tax asset
146,724

After-tax cumulative effect of adopting fair value option accounting

As of January 1, 2008, the Corporation eliminated $\$ 37$ million in allowance for loan losses associated to the loan portfolio elected for fair value option accounting and recognized it as part of the cumulative effect adjustment. The following table presents the differences as of June 30, 2008 between the aggregate fair value, including accrued interest, and aggregate unpaid principal balance ( UPB ) of those loans / notes payable for which the fair value option has been elected. Also, the table presents information of non-accruing loans accounted under the fair value option.

| (In thousands) | $\begin{gathered} \text { Aggregate } \\ \text { fair value } \\ \text { as of } \\ \text { June } 30,2008 \end{gathered}$ | Aggregate <br> UPB as of June 30, 2008 | Unrealized (loss) gain |
| :---: | :---: | :---: | :---: |
| Loans | \$844,892 | \$ 1,345,573 | (\$ 500,681) |
| Loans past due 90 days or more | \$ 110,433 | \$ 194,767 | (\$84,334) |
| Non-accrual loans (1) | \$ 110,433 | \$ 194,767 | (\$84,334) |
| Notes payable (bond certificates) | (\$173,725) | (\$ 253,541) | \$ 79,816 |

## (1)

```
It is the
Corporation s
policy to
recognize
interest income
separately from
other changes in
fair value.
Interest income
is included as
part of net
interest income
in the
consolidated
statement of
operations and
is based on the
note s
contractual rate.
Interest income
is reversed, if
necessary, in
accordance with
the Corporation s
non-accruing
policy for each
particular loan
type.
```

During the quarter and six-months ended June 30, 2008, the Corporation recognized $\$ 31.0$ million and $\$ 32.7$ million, respectively, in estimated net losses attributable to changes in the fair value of loans, including net losses attributable to changes in instrument-specific credit spreads. These estimated net losses were included in the caption Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 in the consolidated statement of operations. The change in fair value included estimated losses of $\$ 6.9$ million for the quarter and $\$ 43.5$ million for the six months ended June 30,2008 that were attributable to changes in instrument-specific credit spreads. Instrument-specific credit spreads were determined by excluding the non-credit components of gains and losses, such as those due to changes in interest rates.
During the quarter and six months ended June 30, 2008, the Corporation recognized $\$ 4.9$ million and $\$ 6.2$ million, respectively, in estimated net losses attributable to changes in the fair value of notes payable (bond certificates),

## Table of Contents

including changes in instrument-specific credit spreads. The estimated net losses were included in the caption Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 in the consolidated statement of operations. The change in fair value included estimated losses of $\$ 5.3$ million for the quarter and $\$ 10.0$ million for the six months ended June 30, 2008 that were attributable to changes in instrument-specific credit spreads.
As indicated in Note 12 to the consolidated financial statements, these assets and liabilities are categorized as Level 3 under the requirements of SFAS No. 157.

## Note 12 Fair Value Measurement

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2008, the Corporation adopted SFAS No. 157, which provides a framework for measuring fair value under accounting principles generally accepted. Under SFAS No. 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.
SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels in order to increase consistency and comparability in fair value measurements and disclosures. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used for the fair value measurement are observable or unobservable. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from independent sources. Unobservable inputs reflect the Corporation s estimates about assumptions that market participants would use in pricing the asset or liability based on the best information available. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1-Unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date. Valuation on these instruments does not necessitate a significant degree of judgment since valuations are based on quoted prices that are readily available in an active market.

Level 2- Quoted prices other than those included in Level 1 that are observable either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or that can be corroborated by observable market data for substantially the full term of the financial instrument.

Level 3- Inputs are unobservable and significant to the fair value measurement. Unobservable inputs reflect the Corporation s own assumptions about assumptions that market participants would use in pricing the asset or liability.
The Corporation maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available. Fair value is based upon quoted market prices when available. If listed price or quotes are not available, the Corporation employs internally-developed models that primarily use market-based inputs including yield curves, interest rates, volatilities, and credit curves, among others. Valuation adjustments are limited to those necessary to ensure that the financial instrument sfair value is adequately representative of the price that would be received or paid in the marketplace. These adjustments include amounts that reflect counterparty credit quality, the Corporation s credit standing, constraints on liquidity and unobservable parameters that are applied consistently.
The estimated fair value may be subjective in nature and may involve uncertainties and matters of significant judgment for certain financial instruments. Changes in the underlying assumptions used in calculating fair value could significantly affect the results. In addition, the fair value estimates are based on outstanding balances without attempting to estimate the value of anticipated future business. Therefore, the estimated fair value may materially differ from the value that could actually be realized on a sale.

## Table of Contents

## Fair Value on a Recurring Basis

The following fair value hierarchy table presents information about the Corporation s assets and liabilities measured at fair value on a recurring basis at June 30, 2008:

|  |  | At June |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Quoted prices in active markets |  |  |  |
|  | for identical | Significant other | Significant |  |
| (In millions) | assets or liabilities Level 1 | observable inputs Level 2 | unobservable inputs Level 3 | Balance as of June 30, 2008 |
| Assets |  |  |  |  |
| Investment securities available-for-sale | \$ 10 | \$ 7,651 | \$ 41 | \$ 7,702 |
| Trading account securities |  | 154 | 345 | 499 |
| Loans measured at fair value (SFAS No. 159) |  |  | 845 | 845 |
| Derivatives |  | 51 |  | 51 |
| Mortgage servicing rights |  |  | 186 | 186 |
| Total | \$ 10 | \$ 7,856 | \$ 1,417 | \$ 9,283 |

## Liabilities

Notes payable measured at fair value (SFAS
No. 159)
Derivatives
(\$ 59)
$\left(\begin{array}{ll}\$ & 174\end{array}\right) \quad\left(\begin{array}{ll}\$ & 174\end{array}\right)$
$\left(\begin{array}{ll}\$ & 59\end{array}\right) \quad\left(\begin{array}{ll}\$ & 174\end{array}\right)$
Total
(\$ 233)
The following tables present the changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter and six months ended June 30, 2008:

Quarter ended June 30, 2008
Changes
in unrealized gains
(losses) included
Purchases, sales, Increase issuances, in earnings related to (decrease) settlements, assets and

Edgar Filing: POPULAR INC - Form 10-Q

|  | $\begin{aligned} & \text { Gains } \\ & \text { (losses) } \end{aligned}$ |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Balance as of | Gains (losses) included | included in other | in accrued interest | paydowns and | Balance as | liabilities still held |
|  | March 31, | in | comprehensi | eceivable <br> / | maturities | of June 30, | as of June |
| (In millions) | 2008 | earnings | income | payable | (net) | 2008 | 30, 2008 |

## Assets

Investment securities

| available-for-sale (e) | $\$ 42$ |  | $(\$ 1)$ | $\$$ | 41 | (a) |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Trading account <br> securities | 280 | $\$ 2$ | 63 | 345 | (\$ 1)(b) |  |
| Loans measured at fair <br> value (SFAS No. 159) | 927 | $(31)$ | $(\$ 1)$ | $(50)$ | 845 | (9)(c) |
| Mortgage servicing <br> rights | 184 | $(9)$ | 11 | 186 | (1)(d) |  |
| Total | $\$ 1,433$ | $(\$ 38)$ | $(\$ 1)$ | $\$ 23$ | $\$ 1,417$ | (\$ 11) |

## Liabilities

Notes payable measured at fair value (SFAS No. 159) $\left(\begin{array}{ll}\$ & 186\end{array}\right) \quad(\$ \quad 5)$ $\$ 17 \quad(\$ 174) \quad(\$ \quad 5)(c)$

Total
(\$ 186) (\$ 5)
$\$ 17 \quad(\$ 174) \quad(\$ \quad 5)$
(a) Gains (losses) are included in Net (loss) gain on sale and valuation adjustments of investment securities in the statement of operations.
(b) Gains (losses) are included in Trading account profit (loss) in the statement of operations.
(c) Gains (losses) are included in Losses from changes in fair value related to
instruments measured at fair value pursuant to SFAS No. 159 in the statement of operations.
(d) Gains (losses) are included in Other service fees in the statement of operations.
(e) Other-than-temporary impairment on residual interests classified as available-for-sale amounted to $\$ 0.6$ million and is classified as realized losses.

## Table of Contents

$\left.\begin{array}{llllll} & & & \begin{array}{c}\text { Changes } \\ \text { in }\end{array} \\ \text { unrealized } \\ \text { gains }\end{array}\right)$

## Assets

| Investment securities available-for-sale (e) | \$ 43 | \$ (2) | \$ |  | \$ (1) | \$ 41 | (a) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Trading account securities | 273 |  |  |  | 72 | 345 | \$ (7)(b) |
| Loans measured at fair value (SFAS No. 159) | 987 | (33) |  | \$ (2) | (107) | 845 | 15(c) |
| Mortgage servicing rights | 192 | (24) |  |  | 18 | 186 | (5)(d) |
| Total | \$1,495 | \$(59) | \$ | \$ (2) | \$ (18) | \$1,417 |  |

## Liabilities

Notes payable measured at fair value (SFAS No. 159)

Total

| $\$(201)$ | $\$(6)$ |
| :--- | :--- |
| $\$(201)$ | $\$(6)$ |


| $\$$ | 33 | $\$(174)$ | $\$(6)(\mathrm{c})$ |
| :--- | :--- | :--- | :--- |
| $\$$ | 33 | $\$(174)$ | $\$(6)$ |

(a) Gains (losses) are included in Net (loss) gain on sale and valuation adjustments of investment securities
in the statement of operations.
(b) Gains (losses) are included in Trading account profit (loss) in the statement of operations.
(c) Gains (losses) are included in Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 in the statement of operations.
(d) Gains (losses) are included in Other service fees in the statement of operations.
(e) Other-than-temporary impairment on residual interests classified as available-for-sale amounted to
$\$ 2.9$ million and is classified as realized losses.

There were no transfers in and / or out of Level 3 for financial instruments measured at fair value on a recurring basis during the quarter and six months ended June 30, 2008.
Gains and losses (realized and unrealized) included in earnings for the quarter and six months ended June 30, 2008 for Level 3 assets and liabilities included in the previous tables are reported in the consolidated statement of operations as follows:
earnings

Interest income
Other service fees
Net loss on sale and valuation adjustments of investment securities
Trading account loss
Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159

Total
 $\$(43)$
(1)
(1)
(36)

## Table of Contents

(In millions)

## Interest income

Other service fees
Net loss on sale and valuation adjustments of investment securities
Trading account loss
Six months ended June 30, 2008
Change in unrealized gains or losses relating to assets /

Total gains (losses) liabilities still held at included in earnings

Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159
\$ 9
(24)
(3)
(8)
(39)
\$ (65)

Total
Additionally, the Corporation may be required to measure certain assets at fair value on a nonrecurring basis in accordance with accounting principles generally accepted. The adjustments to fair value usually result from the application of lower of cost or market accounting, identification of impaired loans requiring specific reserves under SFAS No. 114, or write-downs of individual assets. The following table presents those financial assets that were subject to a fair value measurement on a non-recurring basis during the six months ended June 30, 2008 and which are still included in the consolidated statement of condition as of June 30, 2008. The amounts disclosed represent the aggregate of the fair value measurements of those assets as of the end of the reporting period.

|  | Quoted prices <br> in |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| active | Significant |  |  |  |
|  | markets | other | Significant |  |
| for identical | observable | unobservable |  |  |
| (In millions) | assets | inputs | inputs |  |
|  | Level 1 | Level 2 | Level 3 | Total |

## Assets

Loans (1)
\$ 426
Loans held-for-sale (2)
5
(1) Relates mostly to certain impaired collateral dependent loans. The impairment was measured
based on the fair
value of the
collateral, which
is derived from
appraisals that
take into
consideration
prices in
observed
transactions
involving similar
assets in similar
locations, in
accordance with
the provisions of
SFAS No. 114
(as amended by
SFAS No. 118).
(2) Relates to lower
of cost or market
adjustments on
transfers from
loans
held-in-portfolio
to loans
held-for-sale.

Following is a description of the Corporation $s$ valuation methodologies used for assets and liabilities measured at fair value. The disclosure requirements exclude certain financial instruments and all non-financial instruments.
Accordingly, the aggregate fair value amounts of the financial instruments presented in Note 12 do not represent management s estimate of the underlying value of the Corporation.

## Trading Account Securities and Investment Securities Available-for-Sale

U.S. Treasury securities: The fair value of U.S. Treasury securities is based on yields that are interpolated from the constant maturity treasury curve. These securities are classified as Level 2.

Obligations of U.S. Government sponsored entities: The Obligations of U.S. Government sponsored entities include U.S agency securities. The fair value of U.S. agency securities, except for structured notes, is based on an active exchange market and is based on quoted market prices for similar securities. The U.S. agency securities are classified as Level 2. U.S. agency structured notes are priced based on a bond s theoretical value from similar bonds defined by credit quality and market sector and for which the fair value incorporates an option adjusted spread in deriving their fair value. These securities are classified as Level 2.

Obligations of Puerto Rico, States and political subdivisions: Obligations of Puerto Rico, States and political subdivisions include municipal bonds. The bonds are segregated and the like characteristics divided into specific sectors. Market inputs used in the evaluation process include all or some of the following: trades, bid price or spread, two sided markets, quotes, benchmark curves including but not limited to Treasury benchmarks, LIBOR and swap curves, market data feeds such as MSRB, discount and capital rates, and trustee reports. The municipal bonds are classified as Level 2.

## Table of Contents

Mortgage-backed securities: Certain agency mortgage-backed securities ( MBS ) are priced based on a bond s theoretical value from similar bonds defined by credit quality and market sector. Their fair value incorporates an option adjusted spread. The agency MBS are classified as Level 2. Other agency MBS such as GNMA Puerto Rico Serials are priced using an internally-prepared pricing matrix with quoted prices from local brokers dealers. These particular MBS are classified as Level 3.

Collateralized mortgage obligations: Agency and private collateralized mortgage obligations ( CMOs ) are priced based on a bond $s$ theoretical value from similar bonds defined by credit quality and market sector and for which fair value incorporates an option adjusted spread. The option adjusted spread model includes prepayment and volatility assumptions, ratings (whole loans collateral) and spread adjustments. These investment securities are classified as Level 2.

Equity securities: Equity securities with quoted market prices obtained from an active exchange market are classified as Level 1.

Corporate securities and mutual funds: Quoted prices for these security types are obtained from broker dealers. Given that the quoted prices are for similar instruments or do not trade in highly liquid markets, the corporate securities and mutual funds are classified as Level 2 . The important variables in determining the prices of Puerto Rico tax-exempt mutual fund shares are net asset value, dividend yield and type of assets in the fund. All funds trade based on a relevant dividend yield taking into consideration the aforementioned variables. In addition, demand and supply also affect the price. Corporate securities that trade less frequently are classified as Level 3.

Residual interests: Residual interests do not trade in an active market with readily observable prices and, based on their valuation methodology, are classified as Level 3. The estimated fair value of the residual interests associated to PFH s securitizations is determined by using a cash flow valuation model to calculate the present value of projected future cash flows. All economic assumptions are internally-developed (internal-based valuation). The assumptions, which are highly uncertain and require a high degree of judgment, include primarily market discount rates, anticipated prepayment speeds, delinquency and loss rates. The assumptions used are drawn from a combination of internal and external data sources.

## Derivatives

Interest rate swaps, interest rate caps and index options are traded in over-the-counter active markets. These derivatives are indexed to an observable interest rate benchmark, such as LIBOR or equity indexes, and are priced using present value and option pricing models using observable inputs. The derivatives are substantially classified as Level 2. Other derivatives that are exchange-traded, such as futures and options, or that are liquid and have quoted prices, such as forward contracts or TBA s, are classified as Level 2.

## Mortgage servicing rights

Mortgage servicing rights ( MSRs ) do not trade in an active market with readily observable prices. MSRs are priced internally using a discounted cash flow model. The valuation model considers servicing fees, portfolio characteristics, prepayments assumptions, delinquency rates, late charges, other ancillary revenues, cost to service and other economic factors. Due to the unobservable nature of certain valuation inputs, the MSRs are classified as Level 3.

## Table of Contents

## Loans held-in-portfolio considered impaired under SFAS No. 114 that are collateral dependent

The impairment is measured based on the fair value of the collateral, which is derived from appraisals that take into consideration prices in observed transactions involving similar assets in similar locations, in accordance with the provisions of SFAS No. 114 (as amended by SFAS No. 118). Currently, the associated loans considered impaired as of June 30, 2008 are classified as Level 3.

## Loans measured at fair value pursuant to SFAS No. 159

The fair value of loans measured at fair value pursuant to the SFAS No. 159 election was estimated using discounted cash flow analyses that incorporate assumptions or considerations such as prepayment rates, credit loss estimates, delinquency rates, loss severities, among others. Due to the subprime characteristics of the loan portfolio measured at fair value, the lack of trading activity in that market, and the nature of the valuation inputs, these loans are classified as Level 3. The assumptions used in the valuations were validated by management with market data and other pricing indicators obtained from other sources.

## Notes payable measured at fair value pursuant to SFAS No. 159 (bond certificates associated with PFH s on-balance sheet securitizations)

Bond certificates associated with PFH s on-balance sheet securitizations are measured at fair value on a recurring basis due to the election of the fair value option of SFAS No. 159. The fair value of these bond certificates is derived from discounted cash flow analyses based on historical performance measures, credit risks, interest rate assumptions, and rates of return for similar instruments given the current market environment. The notes payable measured at fair value pursuant to SFAS No. 159 are classified as Level 3.

## Table of Contents

## Note 13 Borrowings

The composition of federal funds purchased and assets sold under agreements to repurchase was as follows:

|  | June 30, | December 31, <br> (In thousands) <br>  <br> Federal funds purchased | June 30, <br> 2007 |
| :--- | ---: | ---: | ---: |
| Assets sold under agreements to repurchase | $\$ 625,000$ | $\$ 303,492$ | $\$ 1,430,952$ |
|  | $4,113,677$ | $5,133,773$ | $4,224,984$ |
|  | $\$ 4,738,677$ | $\$ 5,437,265$ | $\$ 5,655,936$ |

Other short-term borrowings consisted of:

| (In thousands) | June 30, $2008$ | $\begin{gathered} \text { December 31, } \\ 2007 \end{gathered}$ | June 30, 2007 |
| :---: | :---: | :---: | :---: |
| Advances with the FHLB paying interest monthly at fixed rates (June 30, 2007-5.24\% to 5.44\%) |  | \$ 72,000 | \$ 305,000 |
| Advances with the FHLB paying interest at maturity at fixed rates ranging from $2.23 \%$ to $2.40 \%$ | \$ 675,000 | 570,000 |  |
| Advances under credit facilities with other institutions at fixed rates ranging from $2.50 \%$ to $2.94 \%$ (June 30, 2007 $5.35 \%$ to $5.50 \%$ ) | 214,000 | 487,000 | 262,675 |
| Commercial paper paying interest at fixed rates (June 30, 2007-4.75\% to $5.37 \%$ ) |  | 7,329 | 264,239 |
| Term notes purchased paying interest at maturity at fixed rates ranging from $2.20 \%$ to $3.40 \%$ | 6,453 |  |  |
| Term funds purchased at: <br> -fixed rates ranging from $2.26 \%$ to $2.45 \%$ (June 30, 2007 |  |  |  |
| $5.28 \%$ to $5.38 \%$ ) <br> -a floating rate of $0.08 \%$ over the fed funds rate | 439,000 | 280,000 | $\begin{array}{r} 2,065,000 \\ 400,000 \end{array}$ |
| Other | 2,757 | 85,650 | 87,191 |
|  | \$1,337,210 | \$ 1,501,979 | \$3,384,105 |

Note: Refer to the Corporation s Form 10-K for the year ended December 31, 2007, for rates and maturity information corresponding to the borrowings outstanding as of such date. Fed funds rate at June 30, 2008 was $2.50 \%$ and $5.38 \%$ at June 30, 2007.

## Table of Contents

Notes payable consisted of:

|  | December |  |  |
| :---: | :---: | :---: | :---: |
| (In thousands) | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ | $\begin{gathered} 31 \\ 2007 \end{gathered}$ | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |

Advances with the FHLB:
-with maturities ranging from 2008 through 2018 paying interest at fixed rates ranging from $2.67 \%$ to $6.98 \%$ (June 30, $20073.07 \%$ to $6.98 \%$ )
-maturing in 2008 paying interest monthly at a floating rate of $0.0075 \%$ over the 1 -month LIBOR rate

Advances under revolving lines of credit maturing in 2007 paying interest monthly at a floating rate of $0.90 \%$ over the 1 -month LIBOR rate

362,787
Advances under revolving lines of credit with maturities ranging from 2008 to 2009 paying interest quarterly at floating rates ranging from $0.20 \%$ to $0.27 \%$ (June 30, 2007 $0.20 \%$ to $0.35 \%$ ) over the 3-month LIBOR rate

Term notes maturing in 2030 paying interest monthly at fixed rates ranging from $3.00 \%$ to 6.00\%

Term notes with maturities ranging from 2008 to 2013 paying interest semiannually at fixed rates ranging from $3.88 \%$ to $6.85 \%$ (June 30, $20073.35 \%$ to $5.65 \%$ )

Term notes with maturities ranging from 2008 to 2013 paying interest monthly at a
floating rate of $3.00 \%$ over the 10 -year U.S. Treasury note rate
Term notes maturing in 2009 paying interest quarterly at a floating rate of $0.40 \%$ (June 30, $20070.35 \%$ to $0.40 \%$ ) over the 3-month LIBOR rate

Secured borrowings with maturities ranging from 2009 to 2032 paying interest monthly at fixed rates ranging from $6.04 \%$ to $7.04 \%$ (June 30, $20073.86 \%$ to $7.12 \%$ )

Secured borrowings with maturities ranging from 2008 to 2046 paying interest monthly at floating rates ranging from $2.53 \%$ to $3.38 \%$ (June 30, $20070.05 \%$ to $3.50 \%$ ) over the 1-month LIBOR rate

Notes linked to the S\&P 500 Index maturing in 2008
Junior subordinated deferrable interest debentures with maturities ranging from 2027 to 2034 with fixed interest rates ranging from $6.13 \%$ to $8.33 \%$ (Refer to Note 14)

## Other

| 3,100 | 3,100 | 3,100 |
| ---: | ---: | ---: |
| $1,519,021$ | $2,038,259$ | $2,014,659$ |
|  |  |  |
| 5,358 | 6,805 | 8,168 |
|  |  |  |
| 199,822 | 199,706 | 349,504 |
|  |  |  |
| $35,224^{*}$ | 59,241 | $2,489,329$ |
|  |  |  |
| $138,501^{*}$ | 227,743 | $1,352,710$ |
| 32,838 | 36,498 | 38,118 |
|  |  |  |
| 849,672 | 849,672 | 849,672 |
| 29,019 | 26,370 | 21,399 |
| $\$ 3,924,372$ | $\$ 4,621,352$ | $\$ 8,068,638$ |

Note: Refer to the Corporation s Form 10-K for the year ended December 31, 2007, for rates and maturity information corresponding to the borrowings outstanding as of such date. Key index rates as of June 30, 2008 and June 30, 2007,
respectively, were as follows: $1-$ month LIBOR $=2.46 \%$ and $5.32 \% ; 3$-month LIBOR rate $=2.78 \%$ and $5.36 \%$;
10 -year U.S. Treasury note $=3.97 \%$ and $5.03 \%$.

* These secured borrowings are measured at fair value as of June 30, 2008 pursuant to the fair value option election under SFAS No. 159.


## Table of Contents

## Note 14 Trust Preferred Securities

As of June 30, 2008 and 2007, the Corporation had established four trusts for the purpose of issuing trust preferred securities (the capital securities ) to the public. The proceeds from such issuances, together with the proceeds of the related issuances of common securities of the trusts (the common securities ), were used by the trusts to purchase junior subordinated deferrable interest debentures (the junior subordinated debentures ) issued by the Corporation. The sole assets of the trusts consisted of the junior subordinated debentures of the Corporation and the related accrued interest receivable. These trusts are not consolidated by the Corporation under the provisions of FIN No. 46(R). The junior subordinated debentures are included by the Corporation as notes payable in the consolidated statements of condition, while the common securities issued by the issuer trusts are included as other investment securities. The common securities of each trust are wholly-owned, or indirectly wholly-owned, by the Corporation. Financial data pertaining to the trusts follows:
(In thousands, including reference notes)

| Issuer |  | BanPonce Trust I |  | Popular Capital Trust I |  | Popular North America Capital Trust I |  | Popular Capital Trust II |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Issuance date |  | February 1997 |  | October 2003 |  | September 2004 |  | November 2004 |
| Capital securities | \$ | 144,000 | \$ | 300,000 | \$ | 250,000 | \$ | 130,000 |
| Distribution rate |  | 8.327\% |  | 6.700\% |  | 6.564\% |  | 6.125\% |
| Common securities | \$ | 4,640 | \$ | 9,279 | \$ | 7,732 | \$ | 4,021 |
| Junior subordinated debentures aggregate |  |  |  |  |  |  |  |  |
| liquidation amount | \$ | 148,640 | \$ | 309,279 | \$ | 257,732 | \$ | 134,021 |
| Stated maturity date |  | February 2027 |  | November 2033 |  | September 2034 |  | December 2034 |
| Reference notes |  | (a),(c),(e),(f),(g) |  | (b),(d),(f) |  | (a),(c),(f) |  | (b),(d),(f) |

(a) Statutory business trust that is wholly-owned
by Popular North America
( PNA ) and indirectly wholly-owned by the
Corporation.
(b) Statutory
business trust
that is
wholly-owned
by the
Corporation.
(c) The obligations
of PNA under
the junior
subordinated
debentures and
its guarantees of
the capital
securities under
the trust are
fully and
unconditionally
guaranteed on a subordinated basis by the Corporation to the extent set forth in the applicable guarantee agreement.
(d) These capital securities are fully and unconditionally guaranteed on a subordinated basis by the Corporation to the extent set forth in the applicable guarantee agreement.
(e) The original issuance was for $\$ 150,000$. In 2003, the Corporation reacquired $\$ 6,000$ of the 8.327\% capital securities.
(f) The Corporation has the right, subject to any required prior approval from the Federal
Reserve, to redeem after
certain dates or
upon the occurrence of certain events mentioned below, the junior
subordinated
debentures at a
redemption
price equal to
$100 \%$ of the
principal
amount, plus
accrued and
unpaid interest
to the date of redemption. The maturity of the junior subordinated debentures may be shortened at the option of the Corporation prior to their stated maturity dates (i) on or after the stated optional
redemption dates stipulated in the agreements, in whole at any time or in part from time to time, or (ii) in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of a tax event, an investment company event or a capital treatment event
as set forth in the indentures relating to the capital securities, in each case subject to
regulatory
approval. A
capital treatment event would include a change in the regulatory capital treatment of the capital securities as a result of the recent accounting changes affecting the criteria for consolidation of variable interest entities such as the trust under FIN 46(R).
(g) Same as
(f) above, except that the investment company event does not apply
for early
redemption.

The capital securities of Popular Capital Trust I and Popular Capital Trust II are traded on the NASDAQ under the symbols BPOPN and BPOPM, respectively.

## Table of Contents

## Note 15 Stockholders Equity

The Corporation s authorized preferred stock may be issued in one or more series, and the shares of each series shall have such rights and preferences as shall be fixed by the Board of Directors when authorizing the issuance of that particular series.
On May 28, 2008, the Corporation closed the public offering of its Series B Preferred Stock pursuant to an Underwriting Agreement, dated May 22, 2008. The Corporation issued 16,000,000 shares of Series B Preferred Stock at a purchase price of $\$ 25.00$ per share.
The Corporation s preferred stock outstanding at June 30, 2008 consists of:
$6.375 \%$ non-cumulative monthly income preferred stock, 2003 Series A. These shares of preferred stock are perpetual, nonconvertible and are redeemable solely at the option of the Corporation with the consent of the Board of Governors of the Federal Reserve System beginning on March 31, 2008. The redemption price per share is $\$ 25.50$ from March 31, 2008 through March 30, 2009, \$25.25 from March 31, 2009 through March 30, 2010 and $\$ 25.00$ from March 31, 2010 and thereafter.
$8.25 \%$ non-cumulative monthly income preferred stock, 2008 Series B. These shares of preferred stock are perpetual, nonconvertible and are redeemable, in whole or in part, solely at the option of the Corporation with the consent of the Board of Governors of the Federal Reserve System beginning on May 28, 2013. The redemption price per share is $\$ 25.50$ from May 28, 2013 through May 28, 2014, $\$ 25.25$ from May 28, 2014 through May 28, 2015 and $\$ 25.00$ from May 28, 2015 and thereafter.
The Banking Act of the Commonwealth of Puerto Rico requires that a minimum of $10 \%$ of BPPR s net income for the year be transferred to a statutory reserve account until such statutory reserve equals the total of paid-in capital on common and preferred stock. Any losses incurred by a bank must first be charged to retained earnings and then to the reserve fund. Amounts credited to the reserve fund may not be used to pay dividends without the prior consent of the Puerto Rico Commissioner of Financial Institutions. The failure to maintain sufficient statutory reserves would preclude BPPR from paying dividends. BPPR s statutory reserve fund totaled $\$ 374$ million as of June 30, 2008 (December 31, $2007 \$ 374$ million; June 30, $2007 \$ 346$ million). There were no transfers between the statutory reserve account and the retained earnings account during the quarter and six months ended June 30, 2008 and 2007.

## Note 16 Commitments and Contingencies

Commercial letters of credit and stand-by letters of credit amounted to $\$ 21$ million and $\$ 163$ million, respectively, as of June 30, 2008 (December 31, $2007 \quad \$ 26$ million and $\$ 174$ million; June 30, $2007 \quad \$ 15$ million and $\$ 181$ million). There were also other commitments outstanding and contingent liabilities, such as commitments to extend credit. As of June 30, 2008, the Corporation recorded a liability of \$607 thousand (December 31, 2007 - $\$ 636$ thousand; June 30, $2007 \$ 753$ thousand), which represents the fair value of the obligations undertaken in issuing the guarantees under stand-by letters of credit. The fair value approximates the fee received from the customer for issuing such commitments. These fees are deferred and are recognized over the commitment period. The liability was included as part of other liabilities in the consolidated statements of condition. The stand-by letters of credit were issued to guarantee the performance of various customers to third parties. The contract amounts in stand-by letters of credit outstanding represent the maximum potential amount of future payments the Corporation could be required to make under the guarantees in the event of nonperformance by the customers. These stand-by letters of credit are used by the customer as a credit enhancement and typically expire without being drawn upon. The Corporation s stand-by letters of credit are generally secured, and in the event of nonperformance by the customers, the Corporation has rights to the underlying collateral provided, which normally includes cash and marketable securities, real estate, receivables and others. Management does not anticipate any material losses related to these instruments.
Popular, Inc. at the holding company ( PIHC ) fully and unconditionally guarantees certain borrowing obligations issued by certain of its wholly-owned consolidated subsidiaries, which aggregated to $\$ 2.5$ billion as of June 30,2008

## Table of Contents

(December 31, $2007 \$ 2.9$ billion and June 30, 2007 - $\$ 3.4$ billion). In addition, as of June 30, 2008, PIHC fully and unconditionally guaranteed $\$ 824$ million of capital securities (December 31, 2007 and June 30, $2007 \quad \$ 824$ million) issued by four wholly-owned issuing trust entities that have been deconsolidated pursuant to FIN No. 46R.
The Corporation is a defendant in a number of legal proceedings arising in the normal course of business. Based on the opinion of legal counsel, management believes that the final disposition of these matters will not have a material adverse effect on the Corporation s financial position or results of operations.

## Note 17 Other Service Fees

The caption of other service fees in the consolidated statements of operations consists of the following major categories:

|  | Quarter ended |  | Six months ended |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
| June 30, |  | June 30, |  |  |  |
| (In thousands) | 2008 |  | 2007 | 2008 | 2007 |
|  |  |  |  |  |  |
| Credit card fees and discounts | $\$ 27,282$ | $\$ 24,999$ | $\$ 4,526$ | $\$ 48,523$ |  |
| Debit card fees | 26,340 | 16,855 | 51,710 | 32,956 |  |
| Insurance fees | 13,507 | 14,720 | 26,202 | 27,669 |  |
| Processing fees | 13,158 | 11,677 | 25,543 | 23,789 |  |
| Sale and administration of investment <br> products | 8,079 | 7,311 | 19,076 | 14,571 |  |
| Mortgage servicing fees, net of amortization |  |  |  |  |  |
| and fair value adjustments | 11,868 | 4,641 | 18,817 | 10,869 |  |
| Other fees | 9,845 | 9,387 | 19,672 | 19,062 |  |
|  |  |  |  | $\$ 215,546$ | $\$ 177,439$ |

## Note 18 Pension and Postretirement Benefits

The Corporation has noncontributory defined benefit pension plans and supplementary benefit pension plans for regular employees of certain of its subsidiaries.
The components of net periodic pension cost for the quarters and six months ended June 30, 2008 and 2007 were as follows:

| (In thousands) | Pension Plans |  |  |  | Benefit Restoration Plans |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Quarters ended June 30, |  | Six months ended June 30, |  | Quarters ended June 30, |  | Six months ended June 30, |  |
|  | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ 2,315 | \$ 2,639 | \$ 4,630 | \$ 5,745 | \$ 182 | \$ 220 | \$ 364 | \$ 457 |
| Interest cost | 8,611 | 7,959 | 17,222 | 15,932 | 461 | 419 | 922 | 839 |
| Expected return on plan assets | $(10,169)$ | $(10,533)$ | $(20,338)$ | $(21,057)$ | (420) | (368) | (840) | (736) |
| Amortization of prior service cost | 67 | 52 | 134 | 104 | (13) | (13) | (26) | (26) |
| Amortization of net loss |  |  |  |  | 172 | 247 | 343 | 495 |
| Net periodic cost | 824 | 117 | 1,648 | 724 | 382 | 505 | 763 | 1,029 |
| Curtailment gain |  |  |  | (246) |  |  |  | (258) |


| Total cost | $\$$ | 824 | $\$$ | 117 | $\$$ | 1,648 | $\$$ | 478 | $\$ 382$ | $\$ 505$ | $\$ 763$ | $\$ 771$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

For the six months ended June 30, 2008, contributions made to the pension and restoration plans amounted to approximately $\$ 0.8$ million. The total contributions expected to be paid during the year 2008 for the pension and restoration plans amount to approximately $\$ 5.2$ million.

## Table of Contents

The Corporation also provides certain health care benefits for retired employees of certain subsidiaries. The components of net periodic postretirement benefit cost for the quarters and six months ended June 30, 2008 and 2007 were as follows:

|  | Quarters ended |  | Six months ended |  |
| :--- | :---: | ---: | ---: | ---: | ---: |
| June 30, |  |  |  |  |
| In thousands) | 2008 | 2007 | 2008 | 2007 |
| Service cost | $\$ 485$ | $\$ 578$ | $\$ 970$ | $\$ 1,156$ |
| Interest cost | 1,967 | 1,889 | 3,934 | 3,778 |
| Amortization of prior service cost | $(262)$ | $(261)$ | $(524)$ | $(523)$ |
| Total net periodic cost | $\$ 2,190$ | $\$ 2,206$ | $\$ 4,380$ | $\$ 4,411$ |

For the six months ended June 30, 2008, contributions made to the postretirement benefit plan amounted to approximately $\$ 2.8$ million. The total contributions expected to be paid during the year 2008 for the postretirement benefit plan amount to approximately $\$ 6.3$ million.
Note 19 Restructuring Plans

## PFH Branch Network Restructuring Plan

The Corporation closed Equity One s consumer service branches during the first quarter of 2008 as part of the initiatives to exit its subprime loan origination operations at PFH (the PFH Branch Network Restructuring Plan ). PFH continues to hold a $\$ 1.2$ billion maturing loan portfolio as of June 30, 2008. The PFH Branch Network Restructuring Plan followed the sale on March 1, 2008 of approximately $\$ 1.4$ billion of PFH consumer and mortgage loans that were originated through Equity One s consumer branch network to American General Financial ( American General ). The gain on sale of loans and valuation adjustments on loans held-for-sale associated to this portfolio approximated $\$ 47.4$ million for the six months ended June 30, 2008. American General hired certain of Equity One s consumer services employees and retained certain branch locations. During the quarter ended March 31, 2008, Equity One closed substantially all branches not assumed by American General. Full-time equivalent employees at the PFH reportable segment were 321 as of June 30, 2008, compared with 932 as of June 30, 2007. PFH continues to operate a mortgage loan servicing unit, a small scale origination / refinancing unit and to carry a maturing loan portfolio. During the quarter and six months ended June 30, 2008 and as part of this particular restructuring plan, the Corporation incurred (reversed) certain costs, on a pre-tax basis, as detailed in the table below.

|  | Quarter <br> ended <br> June 30, <br> (In thousands) | Six months <br> ended |
| :--- | :---: | :---: |
| Personnel costs | 2008 | June 30, 2008 |
| Net occupancy expenses | $\$ 412$ | $\$ 8,405(\mathrm{a})$ |
| Equipment expenses | $(845)$ | $5,905(\mathrm{~b})$ |
| Communications |  | 675 |
| Other operating expenses | $(\$ 433)$ | $\$ 90$ |
| Total restructuring charges |  | $1,021(\mathrm{c})$ |
|  |  |  |

(a) Severance, retention
bonuses and
other benefits
(b) Lease
terminations
(c) Contract
cancellations
and branch
closing costs
Also, during the fourth quarter of 2007, and as disclosed in the 2007 Annual Report, the Corporation recognized impairment charges on long-lived assets of $\$ 1.9$ million, mainly associated with leasehold improvements, furniture and equipment.

## Table of Contents

As of June 30, 2008, the PFH Branch Network Restructuring Plan has resulted in combined charges for 2007 and 2008, broken down as follows:


The following table presents the changes during 2008 in the reserve for restructuring costs associated with the PFH Branch Network Restructuring Plan.
(In thousands)
Balance at January 1,2008
Charges in quarter ended March 31,2008
Cash payments
Balance at March 31,2008
Charges in quarter ended June 30,2008
Cash payments
Reversals
Balance as of June 30,2008
E-LOAN Restructuring Plan
As indicated in the 2007 Annual Report, in November 2007, the Corporation began a restructuring plan for its Internet
financial services subsidiary E-LOAN (the E-LOAN Restructuring Plan ). This plan included a substantial reduction of
marketing and personnel costs at E-LOAN and changes in E-LOAN s business model. The changes include
concentrating marketing investment toward the Internet and the origination of first mortgage loans that qualify for sale
to government sponsored entities ( GSEs ). Also, as a result of escalating credit costs in the current economic
environment and lower liquidity in the secondary markets for mortgage related products, in the fourth quarter of 2007,
the Corporation determined to hold back the origination by E-LOAN of home equity lines of credit, closed-end second
lien mortgage loans and auto loans. The E-LOAN Restructuring Plan resulted in charges recorded in the fourth quarter
of 2007 amounting to $\$ 231.9$ million, which included $\$ 211.8$ million in non-cash impairment losses related to its
goodwill and trademark intangible assets.
The cost-control plan initiative and changes in loan origination strategies incorporated as part of the plan resulted in
the elimination of over 400 positions between the fourth quarter of 2007 and second quarter of 2008.
The following table presents the changes in restructuring costs reserves for 2008 associated with the E-LOAN
Restructuring Plan.

| (In thousands) | costs |
| :--- | ---: |
| Balance at January 1, 2008 | $\$ 8,808$ |
| Payments | $(4,628)$ |
| Reversals | $(301)$ |
|  |  |
| Balance at March 31, 2008 |  |
| Payments | 3,879 |
| Balance as of June 30, 2008 | $(936)$ |
| The E-LOAN Restructuring Plan charges are part of the results of the BPNA reportable segment. | $\$ 2,943$ |

## Table of Contents

## Note 20 Income Taxes

The reconciliation of unrecognized tax benefits, including accrued interest, was as follows:
(In millions)
Balance as of January 1, 2008
\$22.2
Additions for tax positions January March 2008 1.4
Balance as of March 31, $2008 \quad 23.6$
Additions for tax positions April June 2008 4.4
Balance as of June 30, 2008
As of June 30, 2008, the related accrued interest approximated $\$ 3.6$ million (June 30, $2007 \quad \$ 2.8$ million). Management determined that as of June 30, 2008 and 2007 there was no need to accrue for the payment of penalties. After consideration of the effect on U.S. federal tax of unrecognized U.S. state tax benefits, the total amount of unrecognized tax benefits, including U.S. and Puerto Rico, that if recognized, would affect the Corporation s effective tax rate, was approximately $\$ 26.7$ million as of June 30, 2008 (June 30, 2007 \$23.2 million).
The amount of unrecognized tax benefits may increase or decrease in the future for various reasons including adding amounts for current tax year positions, expiration of open income tax returns due to the statutes of limitation, changes in management s judgment about the level of uncertainty, status of examinations, litigation and legislative activity and the addition or elimination of uncertain tax positions.
The Corporation and its subsidiaries file income tax returns in Puerto Rico, the U.S. federal jurisdiction, various U.S. states and political subdivisions, and foreign jurisdictions. As of June 30, 2008, the following years remain subject to examination in the U.S. Federal jurisdiction: 2006 and thereafter; and in the Puerto Rico jurisdiction, 2003 and thereafter. The U.S. Internal Revenue Service ( IRS ) commenced an examination of the Corporation s U.S. operations tax return for 2006. As of June 30, 2008, the IRS has not proposed any adjustment as a result of the audit. Although the outcomes of the tax audits are uncertain, the Corporation believes that adequate amounts of tax and interest have been provided for any adjustments that are expected to result from open years. The Corporation does not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

## Note 21 Stock-Based Compensation

The Corporation maintained a Stock Option Plan (the Stock Option Plan ), which permitted the granting of incentive awards in the form of qualified stock options, incentive stock options, or non-statutory stock options of the Corporation. In April 2004, the Corporation s shareholders adopted the Popular, Inc. 2004 Omnibus Incentive Plan (the
Incentive Plan ), which replaced and superseded the Stock Option Plan. Nevertheless, all outstanding award grants under the Stock Option Plan continue to remain in effect as of June 30, 2008 under the original terms of the Stock Option Plan.

## Stock Option Plan

Employees and directors of the Corporation or any of its subsidiaries were eligible to participate in the Stock Option Plan. The Board of Directors or the Compensation Committee of the Board had the absolute discretion to determine the individuals that were eligible to participate in the Stock Option Plan. This plan provides for the issuance of Popular, Inc. s common stock at a price equal to its fair market value at the grant date, subject to certain plan provisions. The shares are to be made available from authorized but unissued shares of common stock or treasury stock. The Corporation s policy has been to use authorized but unissued shares of common stock to cover each grant. The maximum option term is ten years from the date of grant. Unless an option agreement provides otherwise, all options granted are $20 \%$ exercisable after the first year and an additional $20 \%$ is exercisable after each subsequent year, subject to an acceleration clause at termination of employment due to retirement.

## Table of Contents

The following table presents information on stock options outstanding as of June 30, 2008:
(Not in thousands)

|  |  | Weighted-Average Remaining |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | Options | Weighted-Average | Life of | Options | Weighted-Average |
|  |  | Exercise | Options |  | Exercise |
| Exercise Price |  |  | Price of | Outstanding | Exercisable | Price of |
| Range | per Share |  | Outstanding | Outstanding | In Years | (fully vested) | Exercisable |
| \$14.39 | \$18.50 | 1,509,952 | \$ 15.81 | 4.23 | 1,508,752 | \$ 15.80 |
| \$19.25 | \$27.20 | 1,547,327 | \$ 25.24 | 5.99 | 1,229,760 | \$ 25.05 |
| \$14.39 | \$27.20 | 3,057,279 | \$ 20.58 | 5.12 | 2,738,512 | \$ 19.96 |

The aggregate intrinsic value of options outstanding as of June 30, 2008 was $\$ 2.1$ million (June 30, 2007 $\$ 12.6$ million). There was no intrinsic value of options exercisable as of June 30, 2008 (June 30, $2007 \$ 1.0$ million). The following table summarizes the stock option activity and related information:

| (Not in thousands) | Options <br> Outstanding | Weighted-Average <br> Exercise Price |
| :--- | ---: | :---: |
| Outstanding at January 1, 2007 | $3,144,799$ | $\$ 20.65$ |
| Granted | $(10,064)$ | 15.83 |
| Exercised | $(19,063)$ | 25.50 |
| Forfeited | $(23,480)$ | 20.08 |
| Expired | $3,092,192$ | $\$ 20.64$ |
| Outstanding as of December 31, 2007 |  |  |
| Granted | $(30,620)$ | 26.13 |
| Exercised | $(4,293)$ | 27.20 |
| Forfeited | $3,057,279$ | $\$ 20.58$ |
| Expired |  |  |
| Outstanding as of June 30, 2008 |  |  |

The stock options exercisable as of June 30, 2008 totaled 2,738,512 (June 30, 2007 2,380,590). There were no stock options exercised during the quarters ended June 30, 2008 and 2007. Thus, there was no intrinsic value of options exercised during the quarters ended June 30, 2008 and 2007. There were no stock options exercised during the six-month period ended June 30, 2008 (June 30, 2007 10,064). Thus, there was no intrinsic value of options exercised during the six-month period ended June 30, 2008 (June 30, 2007 \$28 thousand).
There were no new stock option grants issued by the Corporation under the Stock Option Plan during 2007 and 2008. The Corporation recognized $\$ 0.3$ million of stock option expense, with a tax benefit of $\$ 0.1$ million, for the quarter ended June 30, 2008 (June 30, $2007 \$ 0.4$ million, with a tax benefit of $\$ 0.2$ million). For the six months ended

## Edgar Filing: POPULAR INC - Form 10-Q

June 30, 2008, the Corporation recognized $\$ 0.6$ million of stock option expense, with a tax benefit of $\$ 0.2$ million (June 30, $2007 \$ 0.9$ million, with a tax benefit of $\$ 0.4$ million). The total unrecognized compensation cost as of June 30, 2008 related to non-vested stock option awards was $\$ 1.1$ million and is expected to be recognized over a weighted-average period of 1 year.

## Incentive Plan

The Incentive Plan permits the granting of incentive awards in the form of Annual Incentive Awards, Long-term Performance Unit Awards, Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Units or Performance Shares. Participants in the Incentive Plan are designated by the Compensation Committee of the Board of Directors (or its delegate as determined by the Board). Employees and directors of the Corporation and / or any of its subsidiaries are eligible to participate in the Incentive Plan. The shares may be made available from common stock purchased by the Corporation for such purpose, authorized but unissued shares of common stock or treasury

## Table of Contents

stock. The Corporation s policy with respect to the shares of restricted stock has been to purchase such shares in the open market to cover each grant.
Under the Incentive Plan, the Corporation has issued restricted shares, which become vested based on the employees continued service with Popular. Unless otherwise stated in an agreement, the compensation cost associated with the shares of restricted stock is determined based on a two-prong vesting schedule. The first part is vested ratably over five years commencing at the date of grant and the second part is vested at termination of employment after attainment of 55 years of age and 10 years of service. The five-year vesting part is accelerated at termination of employment after attaining 55 years of age and 10 years of service.
The following table summarizes the restricted stock activity under the Incentive Plan and related information to members of management:

| (Not in thousands) | Restricted Stock | Weighted-Average Grant Date Fair Value |  |
| :---: | :---: | :---: | :---: |
| Non-vested at January 1, 2007 | 611,470 | \$ | 22.55 |
| Granted |  |  |  |
| Vested | $(304,003)$ |  | 22.76 |
| Forfeited | $(3,781)$ |  | 19.95 |
| Non-vested as of December 31, 2007 | 303,686 | \$ | 22.37 |
| Granted |  |  |  |
| Vested | $(50,233)$ |  | 20.33 |
| Forfeited | $(4,134)$ |  | 19.95 |
| Non-vested as of June 30, 2008 | 249,319 | \$ | 22.82 |

During the quarters and six-month periods ended June 30, 2008 and 2007, no shares of restricted stock were awarded to management under the Incentive Plan.
Beginning in 2007, the Corporation authorized the issuance of performance shares, in addition to restricted shares, under the Incentive Plan. The performance shares award consists of the opportunity to receive shares of Popular, Inc. s common stock provided the Corporation achieves certain performance goals during a 3 -year performance cycle. The compensation cost associated with the performance shares will be recorded ratably over a three-year performance period. The performance shares will be granted at the end of the three-year period and will be vested at grant date, except when the participant s employment is terminated by the Corporation without cause. In such case, the participant will receive a pro-rata amount of shares calculated as if the Corporation would have met the performance goal for the performance period. As of June 30, 2008, 6,217 shares have been granted under this plan.
During the quarter ended June 30, 2008, the Corporation recognized $\$ 0.3$ million of restricted stock expense related to management incentive awards, with a tax benefit of $\$ 0.1$ million (June 30, $2007 \quad \$ 0.5$ million, with a tax benefit of $\$ 0.2$ million). For the six-month period ended June 30, 2008, the Corporation recognized $\$ 1.2$ million of restricted stock expense related to management incentive awards, with a tax benefit of $\$ 0.5$ million (June 30, $2007 \quad \$ 1.8$ million, with a tax benefit of $\$ 0.7$ million). The fair market value of the restricted stock vested was $\$ 1.6$ million at grant date and $\$ 0.8$ million at vesting date. This triggers a shortfall of $\$ 0.8$ million that was recorded as an additional income tax expense since the Corporation does not have any surplus due to windfalls. The fair market value of the restricted stock earned was $\$ 20$ thousand. During the quarter and six-month period ended June 30, 2008, the Corporation recognized $\$ 0.5$ million and $\$ 0.9$ million, respectively, of performance shares expense, with a tax benefit of $\$ 0.2$ million and $\$ 0.3$ million, respectively. The total unrecognized compensation cost related to non-vested restricted stock awards and performance shares to members of management as of June 30, 2008 was $\$ 11$ million and is expected to be recognized over a weighted-average period of 2 years.

## Table of Contents

The following table summarizes the restricted stock under the Incentive Plan and related information to members of the Board of Directors:

|  | Restricted | Weighted-Average <br> Grant Date Fair <br> Value |
| :--- | :---: | :---: |
| (Not in thousands) | Stock | $\$ 22.02$ |
| Non-vested at January 1, 2007 | 76,614 | 15.89 |
| Granted | 38,427 | 19.97 |
| Vested | $(115,041)$ |  |
| Forfeited |  | 11.58 |
| Non-vested as of December 31, 2007 | 45,348 | 11.58 |
| Granted | $(45,348)$ |  |

Non-vested as of June 30, 2008

During the quarter ended June 30, 2008, the Corporation granted 41,926 (June 30, 2007 26,751) shares of restricted stock to members of the Board of Directors of Popular, Inc. and BPPR, which became vested at grant date. During the quarter ended June 30,2008 , the Corporation recognized $\$ 0.1$ million of restricted stock expense related to these restricted stock grants, with a tax benefit of $\$ 46$ thousand (June 30, $2007 \quad \$ 0.1$ million, with a tax benefit of $\$ 58$ thousand). For the six-month period ended June 30, 2008, the Corporation granted 45,348 (June 30, 2007 29,363) shares of restricted stock to members of the Board of Directors of Popular Inc. and BPPR, which became vested at grant date. During the six-month period ended June 30, 2008, the Corporation recognized $\$ 0.2$ million of restricted stock expense related to these restricted stock grants, with a tax benefit of \$91 thousand (June 30, $2007 \quad \$ 0.3$ million, with a tax benefit of $\$ 0.1$ million). The fair value at vesting date of the restricted stock vested during 2008 for directors was $\$ 0.5$ million.

## Note 22 Earnings per Common Share

The computation of earnings per common share ( EPS ) follows:

| (In thousands, except share information) | Quarter ended June 30, |  |  |  | Six months ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2008 |  | 2007 |  | 2008 |  | 2007 |
| Net income | \$ | 24,250 | \$ | 74,950 | \$ | 127,540 | \$ | 193,597 |
| Less: Preferred stock dividends |  | 6,003 |  | 2,978 |  | 8,981 |  | 5,956 |
| Net income applicable to common stock | \$ | 18,247 | \$ | 71,972 | \$ | 118,559 | \$ | 187,641 |
| Average common shares outstanding |  | 280,773,513 |  | 279,355,701 |  | 280,514,164 |  | 279,218,147 |
| Average potential common shares |  |  |  | 88,158 |  |  |  | 117,671 |
| Average common shares outstanding |  |  |  |  |  |  |  |  |
| assuming dilution |  | 280,773,513 |  | 279,443,859 |  | 280,514,164 |  | 279,335,818 |


| Basic and diluted EPS | $\$$ | 0.06 | $\$$ | 0.26 | $\$$ | 0.42 | $\$$ | 0.67 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Potential common shares consist of common stock issuable under the assumed exercise of stock options and under restricted stock awards using the treasury stock method. This method assumes that the potential common shares are issued and the proceeds from exercise, in addition to the amount of compensation cost attributed to future services, are used to purchase common stock at the exercise date. The difference between the number of potential shares issued and the shares purchased is added as incremental shares to the actual number of shares outstanding to compute diluted earnings per share. Stock options that result in lower potential shares issued than shares purchased under the treasury stock method are not included in the computation of dilutive earnings per share since their inclusion would have an antidilutive effect in earnings per share. For the quarter and six-month period ended June 30, 2008, there were $3,057,279$ and 3,068,430 weighted average antidilutive stock options outstanding, respectively (June 30, 2007 $1,752,235$ and $1,756,748$ ).

## Table of Contents

Note 23 Supplemental Disclosure on the Consolidated Statements of Cash Flows
Additional disclosures on non-cash activities for the six-month period are listed in the following table:

Non-cash activities:
Loans transferred to other real estate
Loans transferred to other property
Total loans transferred to foreclosed assets
Transfers from loans held-in-portfolio to loans held-for-sale
Transfers from loans held-for-sale to loans held-in-portfolio
Loans securitized into investment securities (a)
Recognition of mortgage servicing rights on securitizations or asset transfers Business acquisitions:
Fair value of assets acquired \$ 52,926

21,219
\$ 90,271

Goodwill and other intangible assets acquired
74,145
422,103
35,482
1,033,032
56,850

Other liabilities assumed703
(a) Includes loans
securitized into
investment
securities and
subsequently
sold before
quarter end.

## Note 24 Segment Reporting

The Corporation s corporate structure consists of four reportable segments Banco Popular de Puerto Rico, Banco Popular North America, Popular Financial Holdings and EVERTEC. Also, a corporate group has been defined to support the reportable segments.
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 organizational structure, which focuses primarily on the markets the segments serve, as well as on the products and services offered by the segments. Also, management has considered its business strategies with respect to the discontinuance of certain loan origination operations of PFH and runoff of its loan portfolio.
Banco Popular de Puerto Rico:
Given that Banco Popular de Puerto Rico constitutes a significant portion of the Corporation s results of operations and total assets as of June 30, 2008, additional disclosures are provided for the business areas included in this reportable segment, as described below:

Commercial banking represents the Corporation s banking operations conducted at BPPR, which are targeted mainly to corporate, small and middle size businesses. It includes aspects of the lending and depository businesses, as well as other finance and advisory services. BPPR allocates funds across segments based on duration matched transfer pricing at market rates. This area also incorporates income related with the investment of excess funds, as well as a proportionate share of the investment function of BPPR.

Consumer and retail banking represents the branch banking operations of BPPR which focus on retail clients. It includes the consumer lending business operations of BPPR, as well as the lending operations of Popular Auto, Popular Finance, and Popular Mortgage. These three subsidiaries focus respectively on auto and lease financing, small personal loans and mortgage loan originations. This area also incorporates income related with
the investment of excess funds from the branch network, as well as a proportionate share of the investment function of BPPR.

Other financial services include the trust and asset management service units of BPPR, the brokerage and investment banking operations of Popular Securities, and the insurance agency and reinsurance businesses of Popular Insurance, Popular Insurance V.I., Popular Risk Services, and Popular Life Re. Most of the services that are provided by these subsidiaries generate profits based on fee income.

## Table of Contents

## Banco Popular North America:

Banco Popular North America s reportable segment consists of the banking operations of BPNA, E-LOAN, Popular Equipment Finance, Inc. and Popular Insurance Agency, U.S.A. BPNA operates through a branch network with presence in 6 states, while E-LOAN provides online consumer direct lending and supports BPNA s deposit gathering through its online platform. Popular Insurance Agency, U.S.A. offers investment and insurance services across the BPNA branch network. Popular Equipment Finance, Inc. specializes in financing manufacturing, commercial and healthcare equipment in various markets. The U.S. operations also include the mortgage business unit of Banco Popular, National Association.
Due to the significant losses in the E-LOAN operations during 2007, impacted in part by the restructuring charges and impairment losses that resulted from the restructuring plan effected in 2007, management has determined to provide as additional disclosure the results of E-LOAN apart from the other BPNA subsidiaries.

## Popular Financial Holdings:

PFH, after certain restructuring events discussed in Note 19 to the consolidated financial statements, exited the branch network loan origination business during the first quarter of 2008, but continues to operate a small scale origination / refinancing unit, to carry a maturing loan portfolio and to operate a mortgage loan servicing unit. PFH s clientele is primarily subprime borrowers. PFH continues to carry a maturing loan portfolio that approximated $\$ 1.2$ billion as of June 30, 2008.

## EVERTEC:

This reportable segment includes the financial transaction processing and technology functions of the Corporation, including EVERTEC, with offices in Puerto Rico, Florida, the Dominican Republic and Venezuela; EVERTEC USA, Inc. incorporated in the United States; and ATH Costa Rica, S.A., EVERTEC LATINOAMERICA, SOCIEDAD ANONIMA and T.I.I. Smart Solutions Inc. located in Costa Rica. In addition, this reportable segment includes the equity investments in Consorcio de Tarjetas Dominicanas, S.A. ( CONTADO ) and Servicios Financieros, S.A. de C.V. ( Serfinsa ), which operate in the Dominican Republic and El Salvador, respectively. This segment provides processing and technology services to other units of the Corporation as well as to third parties, principally other financial institutions in Puerto Rico, the Caribbean and Central America.
The Corporate group consists primarily of the holding companies: Popular, Inc., Popular North America and Popular International Bank, excluding the equity investments in CONTADO and Serfinsa, which due to the nature of their operations are included as part of the EVERTEC segment. The holding companies obtain funding in the capital markets to finance the Corporation s growth, including acquisitions. The Corporate group also includes the expenses of the four administrative corporate areas that are identified as critical for the organization: Finance, Risk Management, Legal and People, and Communications. These corporate administrative areas have the responsibility of establishing policy, setting up controls and coordinating the activities of their corresponding groups in each of the reportable segments.
The Corporation may periodically reclassify reportable segment results based on modifications to its management reporting and profitability measurement methodologies and changes in organizational alignment.

## Table of Contents

The accounting policies of the individual operating segments are the same as those of the Corporation described in Note 1. Transactions between reportable segments are primarily conducted at market rates, resulting in profits that are eliminated for reporting consolidated results of operations.

2008
For the quarter ended June 30, 2008

| (In thousands) | Banco Popular de Puerto Rico |  | Banco Popular North America |  | Popular |  |  |  | Intersegment Eliminations |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Financial Holdings | EVERTEC |  |  |  |
| Net interest income (expense) | \$ | 243,211 |  |  | \$ | 92,363 | \$ | 7,595 | \$ | (234) |  |  |
| Provision for loan losses |  | 107,755 |  | 81,410 |  | 1,475 |  |  |  |  |
| Non-interest income (loss) |  | 185,072 |  | 29,275 |  | $(43,575)$ |  | 65,862 |  | $(36,569)$ |
| Amortization of intangibles |  | 765 |  | 1,506 |  |  |  | 219 |  |  |
| Depreciation expense |  | 10,537 |  | 3,674 |  | 275 |  | 3,570 |  | (18) |
| Other operating expenses |  | 197,188 |  | 94,146 |  | 17,121 |  | 44,002 |  | $(37,307)$ |
| Income tax expense (benefit) |  | 19,553 |  | $(24,779)$ |  | $(19,057)$ |  | 4,346 |  | 240 |
| Net income (loss) | \$ | 92,485 | \$ | $(34,319)$ | \$ | $(35,794)$ |  | 13,491 | \$ | 516 |
| Segment Assets |  | ,524,462 |  | ,873,833 |  | 2,012,956 |  | 49,160 |  | 183,029) |

For the quarter ended June 30, 2008

| (In thousands) | Reportable <br> Segments |  | Corporate |  | Eliminations |  | Total <br> Popular, Inc. |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net interest income (expense) | \$ | 342,935 | \$ | $(5,349)$ | \$ | 299 | \$ | 337,885 |
| Provision for loan losses |  | 190,640 |  |  |  |  |  | 190,640 |
| Non-interest income |  | 200,065 |  | 976 |  | $(7,469)$ |  | 193,572 |
| Amortization of intangibles |  | 2,490 |  |  |  |  |  | 2,490 |
| Depreciation expense |  | 18,038 |  | 569 |  |  |  | 18,607 |
| Other operating expenses |  | 315,150 |  | 15,086 |  | $(3,600)$ |  | 326,636 |
| Income tax benefit |  | $(19,697)$ |  | $(11,555)$ |  | 86 |  | $(31,166)$ |
| Net income (loss) | \$ | 36,379 | \$ | $(8,473)$ |  | $(\$ 3,656)$ | \$ | 24,250 |
| Segment Assets |  | ,477,382 |  | , 02,462 |  | ,701,250) |  | ,678,594 |

## For the six months ended June 30, 2008

|  |  |  | Popular |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
|  | Banco Popular | Banco |  |  |  |
| (In thousands) | de | Popular | Financial |  | Intersegment |
|  | Puerto Rico |  | Holdings | EVERTEC | Eliminations |


|  | North <br> America |  |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Net interest income (expense) | $\$ 487,883$ | $\$ 187,803$ | $\$ 28,991$ | $\$$ | $(469)$ | $\$$ | 53 |
| Provision for loan losses | 210,234 | 140,127 | 8,461 |  |  |  |  |
| Non-interest income (loss) | 362,758 | 83,097 | $(352)$ | 135,572 | $(74,232)$ |  |  |
| Amortization of intangibles | 1,508 | 3,021 |  | 453 |  |  |  |
| Depreciation expense | 21,004 | 7,268 | 649 | 7,280 | $(36)$ |  |  |
| Other operating expenses | 384,517 | 184,820 | 65,965 | 92,265 | $(74,812)$ |  |  |
| Income tax expense (benefit) | 42,065 | $(28,044)$ | $(14,681)$ | 9,852 | 208 |  |  |
|  |  |  |  |  |  |  |  |
| Net income (loss) | $\$ 191,313$ | $\$(36,292)$ | $\$(31,755)$ | $\$ 25,253$ | $\$$ | 461 |  |

## Table of Contents

## For the six months ended June 30, 2008

|  | Total <br> Reportable <br> Segments | Corporate | Eliminations | Total <br> Popular, Inc. |
| :--- | ---: | :---: | :---: | :---: |
| (In thousands) | $\$ 704,261$ | $\$(9,785)$ | $\$ 598$ | $\$ 695,074$ |
| Net interest income (expense) | 358,822 | 40 |  | 358,862 |
| Provision for loan losses | 506,843 | 3,719 | $(9,015)$ | 501,547 |
| Non-interest income | 4,982 |  |  | 4,982 |
| Amortization of intangibles | 36,165 | 1,153 |  | 37,318 |
| Depreciation expense | 652,755 | 30,789 | $(5,596)$ | 677,948 |
| Other operating expenses | 9,400 | $(19,808)$ | 379 | $(10,029)$ |
| Income tax expense (benefit) |  |  |  |  |
|  | $\$ 148,980$ | $\$(18,240)$ | $\$(3,200)$ | $\$ 127,540$ |

2007

For the quarter ended June 30, 2007

| (In thousands) | Banco Popular de Puerto Rico |  |  | Banco |  | Popular | EVERTEC |  | Intersegment Eliminations |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Popular North America |  | Financial Holdings |  |  |  |  |  |
| Net interest income (expense) | \$ | 237,154 | \$ | 91,954 | \$ | 46,755 | \$ | (240) | \$ | 867 |
| Provision for loan losses |  | 63,482 |  | 12,217 |  | 39,468 |  |  |  |  |
| Non-interest income |  | 125,090 |  | 45,667 |  | 11,751 |  | 59,853 |  | $(35,078)$ |
| Amortization of intangibles |  | 656 |  | 1,938 |  |  |  | 219 |  |  |
| Depreciation expense |  | 10,441 |  | 4,059 |  | 647 |  | 4,256 |  | (18) |
| Other operating expenses |  | 179,164 |  | 107,070 |  | 30,018 |  | 44,729 |  | $(35,108)$ |
| Income tax expense (benefit) |  | 27,887 |  | 3,905 |  | $(3,552)$ |  | 3,814 |  | 374 |
| Net income (loss) | \$ | 80,614 | \$ | 8,432 | \$ | $(8,075)$ | \$ | 6,595 | \$ | 541 |
| Segment Assets |  | ,863,421 |  | ,914,122 |  | 759,262 |  | 33,167 |  | 50,730) |

For the quarter ended June 30, 2007

|  | Total <br> Reportable <br> Segments | Corporate | Eliminations | Total <br> Popular, Inc. |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| (In thousands) |  |  |  |  |  |  |
| Net interest income (expense) | $\$ 76,490$ | $\$$ | $(5,373)$ | $\$$ | 300 | $\$ 71,417$ |
| Provision for loan losses | 115,167 |  |  |  | 115,167 |  |
| Non-interest income (loss) | 207,283 | $(1,614)$ |  | $(2,294)$ | 203,375 |  |
| Amortization of intangibles | 2,813 |  |  |  | 2,813 |  |
| Depreciation expense | 19,385 | 594 |  | 19,979 |  |  |

Edgar Filing: POPULAR INC - Form 10-Q

| Other operating expenses |  | 325,873 |  | 14,218 |  | $(1,830)$ |  | 338,261 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Income tax expense (benefit) |  | 32,428 |  | $(8,750)$ |  | (56) |  | 23,622 |
| Net income (loss) | \$ | 88,107 | \$ | $(13,049)$ | \$ | (108) | \$ | 74,950 |
| Segment Assets |  | 619,242 |  | 471,299 |  | 05,178) |  | ,985,363 |

## Table of Contents

For the six months ended June 30, 2007

|  | Banco Popular <br> de | Banco <br> Popular <br> North | Popular |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Puerto Rico | America | Holdings | EVERTEC | Intersegment <br> Eliminations |  |
| Net interest income (expense) | $\$ 469,378$ | $\$ 181,738$ | $\$ 88,409$ | $\$$ | $(473)$ | $\$ 1,524$ |
| Provision for loan losses | 110,480 | 22,650 | 78,376 |  |  |  |
| Non-interest income (loss) | 241,842 | 102,609 | $(50,603)$ | 119,475 | $(82,305)$ |  |
| Amortization of intangibles | 1,318 | 4,011 |  | 467 |  |  |
| Depreciation expense | 21,165 | 8,082 | 1,260 | 8,320 | $(36)$ |  |
| Other operating expenses | 352,992 | 212,757 | 81,338 | 88,625 | $(69,824)$ |  |
| Income tax expense (benefit) | 58,382 | 12,902 | $(42,708)$ | 7,749 | $(4,472)$ |  |
|  |  |  |  |  |  |  |
| Net income (loss) | $\$ 166,883$ | $\$ 23,945$ | $\$(80,460)$ | $\$ 13,841$ | $\$(6,449)$ |  |

For the six months ended June 30, 2007

|  | Total <br> Reportable <br> Segments | Corporate |
| :--- | ---: | :---: | ---: | ---: | ---: | Eliminations | Total |
| :---: |
| Popular, |
| Inc. |

During the six months ended June 30, 2007, the Corporate group realized net gains on sale and valuation adjustments of investment securities, mainly marketable equity securities, of approximately $\$ 108.1$ million before tax. There were no realized net gains on sale of securities recorded by the Corporate group during the six-month period ended June 30, 2008. These net gains are included in non-interest income within the Corporate group.

Additional disclosures with respect to the Banco Popular de Puerto Rico reportable segment are as follows:
2008
For the quarter ended June 30, 2008

| (In thousands) | Commercial Banking |  | Consumer and Retail Banking |  | Other <br> Financial Services |  | Eliminations |  | Total Banco <br> Popular de Puerto Rico |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |  |  |  |  |  |
| Net interest income | \$ | 88,401 | \$ | 151,596 | \$ | 3,070 | \$ | 144 | \$ | 243,211 |
| Provision for loan losses |  | 61,150 |  | 46,605 |  |  |  |  |  | 107,755 |
| Non-interest income |  | 35,755 |  | 118,265 |  | 31,145 |  | (93) |  | 185,072 |

Edgar Filing: POPULAR INC - Form 10-Q

| 765 |  |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Amortization of intangibles | 31 | 572 | 162 |  |  | 10,537 |
| Depreciation expense | 3,825 | 6,416 | 296 |  | $(96)$ | 197,188 |
| Other operating expenses | 55,244 | 123,846 | 18,194 | 69 | 19,553 |  |
| Income tax (benefit) expense | $(5,875)$ | 20,025 | 5,334 |  | 78 | $\$$ |
| Net income |  |  |  |  | 92,485 |  |
|  | $\$, 781$ | $\$$ | 72,397 | $\$ 10,229$ | $\$$ |  |
| Segment Assets | $\$ 11,461,433$ | $\$ 19,066,945$ | $\$ 791,390$ | $\$(4,795,306)$ | $\$ 26,524,462$ |  |

## Table of Contents

For the six months ended June 30, 2008


Total Banco
Other
(In thousands)
Net interest income
Provision for loan losses
Non-interest income
Amortization of intangibles
Depreciation expense
Other operating expenses
Income tax expense

| Net income | $\$$ | 32,516 | $\$$ | 42,339 | $\$ 5,960$ | $\$$ | $(201)$ | $\$ 80,614$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Segment Assets | $\$ 11,422,905$ | $\$ 18,081,721$ | $\$ 724,346$ | $\$(4,365,551)$ | $\$ 25,863,421$ |  |  |  |

For the six months ended June 30, 2007

|  | Commercial | Consumer <br> and <br> Retail | Other <br> Financial |  | Total Banco |
| :--- | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Banking | Banking | Services | Eliminations | Puerto Rico |
| Net interest income | $\$ 184,182$ | $\$ 279,736$ | $\$ 5,180$ | $\$ 280$ | $\$ 469,378$ |
| Provision for loan losses | 35,822 | 74,658 |  |  | 110,480 |
| Non-interest income | 45,107 | 154,575 | 42,807 | (647) | 241,842 |

Edgar Filing: POPULAR INC - Form 10-Q

| 1,318 |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Amortization of intangibles | 440 | 658 | 220 |  | 21,165 |
| Depreciation expense | 7,378 | 13,214 | 573 |  | $(179)$ |
| Other operating expenses | 88,353 | 231,927 | 32,891 | 352,992 |  |
| Income tax expense | 27,400 | 26,722 | 4,328 | $(68)$ | 58,382 |
|  |  |  |  |  |  |
| Net income | $\$ 99,896$ | $\$ 87,132$ | $\$ 9,975$ | $\$(120)$ | $\$ 166,883$ |

## Table of Contents

Additional disclosures with respect to the Banco Popular North America reportable segment are as follows:
2008
For the quarter ended June 30, 2008

| (In thousands) | Banco Popular North America |  | E-LOAN |  | Eliminations |  | Banco Popular North America |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net interest income | \$ | 84,666 | \$ | 7,350 | \$ | 347 | \$ | 92,363 |
| Provision for loan losses |  | 55,066 |  | 26,344 |  |  |  | 81,410 |
| Non-interest income |  | 26,246 |  | 3,263 |  | (234) |  | 29,275 |
| Amortization of intangibles |  | 1,057 |  | 449 |  |  |  | 1,506 |
| Depreciation expense |  | 3,205 |  | 469 |  |  |  | 3,674 |
| Other operating expenses |  | 73,976 |  | 20,167 |  | 3 |  | 94,146 |
| Income tax benefit |  | $(9,723)$ |  | $(15,094)$ |  | 38 |  | $(24,779)$ |
| Net loss | \$ | $(12,669)$ | \$ | $(21,722)$ | \$ | 72 | \$ | $(34,319)$ |
| Segment Assets |  | 151,497 |  | ,053,195 |  | 0,859) |  | 873,833 |

For the six months ended June 30, 2008


| (In thousands) | Banco Popular North America |  | E-LOAN |  | Eliminations |  | Total Banco Popular North America |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net interest income | \$ | 87,949 | \$ | 3,795 | \$ | 210 | \$ | 91,954 |
| Provision for loan losses |  | 10,756 |  | 1,461 |  |  |  | 12,217 |
| Non-interest income |  | 24,261 |  | 21,762 |  | (356) |  | 45,667 |
| Amortization of intangibles |  | 1,240 |  | 698 |  |  |  | 1,938 |

Edgar Filing: POPULAR INC - Form 10-Q

| Depreciation expense | 3,240 |  | 819 |  | 4,059 |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Other operating expenses | 69,086 | 37,973 |  | 11 | 107,070 |  |
| Income tax expense (benefit) | 10,271 | $(6,312)$ |  | $(54)$ | 3,905 |  |
|  |  |  |  |  |  |  |
| Net income (loss) | $\$ 17,617$ | $\$$ | $(9,082)$ | $\$$ | $(103)$ | $\$$ |
|  |  |  |  | 8,432 |  |  |
| Segment Assets | $\$ 12,897,767$ | $\$ 1,006,336$ | $\$(989,981)$ | $\$ 12,914,122$ |  |  |

## Table of Contents

For the six months ended June 30, 2007

|  | Banco <br> Popular <br> North |  |  | Total Banco <br> Popular <br> North |
| :--- | ---: | ---: | ---: | ---: | ---: |
| (In thousands) | America | E-LOAN | Eliminations | America |
| Net interest income | $\$ 173,913$ | $\$ 7,441$ | $\$ 384$ | $\$ 181,738$ |
| Provision for loan losses | 19,635 | 3,015 |  | 22,650 |
| Non-interest income | 48,386 | 54,844 | $(621)$ | 102,609 |
| Amortization of intangibles | 2,616 | 1,395 |  | 4,011 |
| Depreciation expense | 6,491 | 1,591 |  | 8,082 |
| Other operating expenses | 138,607 | 74,127 | 23 | 212,757 |
| Income tax expense (benefit) | 20,312 | $(7,319)$ | $(91)$ | 12,902 |
|  |  |  |  |  |
| Net income (loss) | $\$ 34,638$ | $\$(10,524)$ | $\$(169)$ | $\$ 23,945$ |

A breakdown of intersegment eliminations, particularly revenues, by segment in which the revenues are recorded follows:

## INTERSEGMENT REVENUES*

|  | Quarter ended |  | Six months ended |  |  |
| :--- | :---: | :---: | ---: | ---: | ---: |
|  | June 30, | June 30, | June 30, | June 30, |  |
| (In thousands) | 2008 | 2007 | 2008 | 2007 |  |
|  |  |  |  |  |  |
| Banco Popular de Puerto Rico: | $\$ 212$ | $\$$ | $(64)$ | $\$$ | 612 |
| Commercial Banking | 491 | $(163)$ | 1,414 | $(58)$ |  |
| Consumer and Retail Banking | $(97)$ | $(102)$ | $(130)$ | $(231)$ |  |
| Other Financial Services |  |  |  |  |  |
| Banco Popular North America: | $(1,347)$ | $(1,081)$ | $(4,335)$ | $(1,108)$ |  |
| Banco Popular North America |  | $(73)$ | $(627)$ | $(12,613)$ |  |
| E-LOAN | 1,999 | 1,943 | 3,721 | 2,246 |  |
| Popular Financial Holdings | $(37,827)$ | $(34,671)$ | $(74,834)$ | $(68,839)$ |  |
| EVERTEC |  |  |  |  |  |
|  | $\$(36,569)$ | $\$(34,211)$ | $\$(74,179)$ | $\$(80,781)$ |  |

* For purposes of the intersegment revenues disclosure, revenues include interest income (expense) related to internal funding and other income derived from
intercompany
transactions,
mainly related to
processing / information technology services.


## Table of Contents

A breakdown of revenues and selected balance sheet information by geographical area follows:

## Geographic Information

| (In thousands) | Quarter ended |  | Six months ended |  |
| :---: | :---: | :---: | :---: | :---: |
|  | June 30, $2008$ | June 30, 2007 | June 30, 2008 | June 30, 2007 |
| Revenues** |  |  |  |  |
| Puerto Rico | \$426,504 | \$362,811 | \$ 849,106 | \$ 840,796 |
| United States | 78,272 | 190,244 | 288,844 | 297,483 |
| Other | 26,681 | 21,737 | 58,671 | 43,671 |
| Total consolidated revenues | \$531,457 | \$574,792 | \$1,196,621 | \$ 1,181,950 |
| ** Total revenues include net interest income, service charges on deposit accounts, other service fees, net gain (loss) on sale and valuation adjustments of investment securities, trading account profit (loss), losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159, gain on sale of loans and valuation adjustments on loans held-for-sale, and other operating income. |  |  |  |  |


|  | June 30, | December 31, | June 30, |
| :--- | :---: | :---: | :---: |
| (In thousands) | 2008 | 2007 | 2007 |

Selected Balance Sheet Information:

Puerto Rico

| Total assets | $\$ 25,352,860$ | $\$ 26,017,716$ | $\$ 24,996,466$ |
| :--- | ---: | ---: | ---: |
| Loans | $15,442,742$ | $15,679,181$ | $15,129,703$ |
| Deposits | $16,462,795$ | $17,341,601$ | $14,237,308$ |
| Mainland United States |  |  |  |
| Total assets | $\$ 15,033,702$ | $\$ 17,093,929$ | $\$ 20,733,903$ |
| Loans | $11,524,665$ | $13,517,728$ | $16,955,769$ |
| Deposits | $9,342,281$ | $9,737,996$ | $9,900,375$ |
| Other |  |  |  |
| Total assets | $\$ 1,292,032$ | $\$ 1,299,792$ | $\$ 1,254,994$ |
| Loans | 664,271 | 714,093 | 666,373 |
| Deposits * | $1,310,652$ | $1,254,881$ | $1,248,312$ |

* Represents deposits from BPPR operations located in the U.S. and British Virgin Islands.
Note 25 Condensed Consolidating Financial Information of Guarantor and Issuers of Registered Guaranteed Securities
The following condensed consolidating financial information presents the financial position of Popular, Inc. Holding Company ( PIHC ) (parent only), Popular International Bank, Inc. ( PIBI ), Popular North America, Inc. ( PNA ), and all other subsidiaries of the Corporation as of June 30, 2008, December 31, 2007 and June 30, 2007, and the results of their operations and cash flows for the periods ended June 30, 2008 and 2007.
PIBI is an operating subsidiary of PIHC and is the holding company of its wholly-owned subsidiaries: ATH Costa Rica S.A., EVERTEC LATINOAMERICA, SOCIEDAD ANONIMA, T.I.I. Smart Solutions Inc., Popular Insurance V.I., Inc. and PNA.

PNA is an operating subsidiary of PIBI and is the holding company of its wholly-owned subsidiaries:
PFH, including its wholly-owned subsidiaries Equity One, Inc., Popular Financial Management, LLC, Popular Housing Services, Inc., and Popular Mortgage Servicing, Inc.;

Banco Popular North America ( BPNA ), including its wholly-owned subsidiaries Popular Equipment Finance, Inc., Popular Insurance Agency, U.S.A., Popular FS, LLC and E-LOAN, Inc.;

Banco Popular, National Association ( BP, N.A. ), including its wholly-owned subsidiary Popular Insurance, Inc.; and

EVERTEC USA, Inc.

## Table of Contents

PIHC, PIBI and PNA are authorized issuers of debt securities and preferred stock under a shelf registration filed with the Securities and Exchange Commission.
PIHC fully and unconditionally guarantees all registered debt securities and preferred stock issued by PNA. The principal source of income for the PIHC consists of dividends from BPPR. As members subject to the regulations of the Federal Reserve System, BPPR and BPNA must obtain the approval of the Federal Reserve Board for any dividend if the total of all dividends declared by each entity during the calendar year would exceed the total of its net income for that year, as defined by the Federal Reserve Board, combined with its retained net income for the preceding two years, less any required transfers to surplus or to a fund for the retirement of any preferred stock. The payment of dividends by BPPR may also be affected by other regulatory requirements and policies, such as the maintenance of certain minimum capital levels. As of June 30, 2008, BPPR could have declared a dividend of approximately $\$ 110$ million (December 31, $2007 \$ 45$ million; June 30, $2007 \$ 192$ million) without the approval of the Federal Reserve Board. As of June 30, 2008, BPNA was required to obtain the approval of the Federal Reserve Board to declare a dividend. The Corporation has never received dividend payments from its U.S. subsidiaries. Refer to Popular, Inc. s Form 10-K for the year ended December 31, 2007 for further information on dividend restrictions imposed by regulatory requirements and policies on the payment of dividends by BPPR, BPNA and BP, N.A.

## Table of Contents

## POPULAR, INC.

CONDENSED CONSOLIDATING STATEMENT OF CONDITION
JUNE 30, 2008
(UNAUDITED)

|  | Popular, Inc. | PIBI | PNA | All other <br> subsidiaries <br> and | Elimination | Popular, Inc. |
| :--- | :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Holding Co. | Holding Co. | Holding Co. | eliminations | entries | Consolidated |

## ASSETS

Cash and due from

| banks | $\$$ | 904 | $\$$ | 285 | $\$$ | 7,646 | $\$$ | 879,893 | $\$$ | $(1,109)$ | $\$$ | 887,619 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Money market <br> investments |  | 435,200 |  | 38,700 |  | 207 |  | 897,796 |  | $(474,107)$ |  | 897,796 |

Investment securities available-for-sale, at fair value
Investment securities held-to-maturity, at amortized cost Other investment securities, at lower of cost or realizable value Trading account securities, at fair value Investment in subsidiaries
Loans held-for-sale measured at lower of cost or market value Loans measured at fair value pursuant to SFAS No. 159

Loans held-in-portfolio

| 739,360 | $1,685,000$ | $26,633,984$ | $(2,422,340)$ | $26,636,004$ |
| ---: | ---: | ---: | ---: | ---: |
|  |  | 186,770 |  | 186,770 |
| 60 |  | 652,670 |  | 652,730 |
| 739,300 | $1,685,000$ | $25,794,544$ | $(2,422,340)$ | $25,796,504$ |

Premises and

| equipment, net | 22,679 |  | 131 | 610,640 |  | 633,450 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Other real estate | 47 |  |  | 102,762 |  | 102,809 |
| Accrued income |  |  |  |  |  |  |
| receivable | 725 | 119 | 8,044 | 162,829 | $(8,443)$ | 163,274 |
| Servicing assets |  |  |  | 190,778 |  | 190,778 |
| Other assets | 34,320 | 63,450 | 66,159 | $2,335,114$ | $(43,201)$ | $2,455,842$ |

Edgar Filing: POPULAR INC - Form 10-Q

| Goodwill |  |  | 628,826 |  | 628,826 |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Other intangible assets | 554 |  | 63,669 |  | 64,223 |
|  |  | $\$ 4,251,177$ | $\$ 420,852$ | $\$ 3,264,824$ | $\$ 41,460,190$ |$\$(7,718,449) \quad \$ 41,678,594$

## LIABILITIES AND <br> STOCKHOLDERS EQUITY

Liabilities:
Deposits:
Non-interest bearing Interest bearing

| $\$ 4,483,338$ |  |  |  |
| ---: | ---: | ---: | ---: |
| $22,672,348$ | $\$$ | $(1,051)$ | $\$ 4,482,287$ |
|  |  | $(38,907)$ | $22,633,441$ |
| $27,155,686$ |  | $(39,958)$ | $27,115,728$ |

Federal funds purchased and assets sold under agreements to repurchase Other short-term borrowings
Notes payable at cost
\$ 476,639

| $\$ 223,500$ | $4,950,377$ | $(435,200)$ | $4,738,677$ |
| ---: | ---: | ---: | ---: |
| 479,193 | $1,796,357$ | $(938,340)$ | $1,337,210$ |
| $2,212,215$ | $2,546,294$ | $(1,484,501)$ | $3,750,647$ |
|  | 173,725 |  |  |
|  | 430,000 | $(430,000)$ | 173,725 |
| 69,684 | 769,459 | $(51,276)$ | 856,504 |
|  |  |  |  |
| $2,984,592$ | $37,821,898$ | $(3,379,275)$ | $37,972,491$ |

Minority interest in consolidated subsidiaries $109 \quad 109$

Stockholders equity:

| Preferred stock | 586,875 |  |  |  | 586,875 |  |
| :--- | ---: | :---: | ---: | ---: | ---: | ---: |
| Common stock | $1,767,721$ | 3,961 | 2 | 51,819 | $(55,782)$ | $1,767,721$ |
| Surplus | 554,306 | 851,193 | 734,964 | $2,810,895$ | $(4,388,258)$ | 563,100 |
| Retained earnings | $1,095,167$ | $(378,975)$ | $(448,860)$ | 815,083 | 3,958 | $1,086,373$ |

Accumulated other comprehensive loss, net of tax
Treasury stock, at cost

| $(90,448)$ | $(55,420)$ | $(5,874)$ | $(39,122)$ | 100,416 | $(90,448)$ |
| ---: | ---: | ---: | ---: | ---: | ---: |
| $(207,627)$ |  |  | $(492)$ | 492 | $(207,627)$ |
| $3,705,994$ | 420,759 | 280,232 | $3,638,183$ | $(4,339,174)$ | $3,705,994$ |
| $\$ 4,251,177$ | $\$ 420,852$ | $\$ 3,264,824$ | $\$ 41,460,190$ | $\$(7,718,449)$ | $\$ 41,678,594$ |

## Table of Contents

## POPULAR, INC.

CONDENSED CONSOLIDATING STATEMENT OF CONDITION
DECEMBER 31, 2007
(UNAUDITED)

|  | Popular, Inc. | PIBI | PNA | All other <br> subsidiaries <br> and | Elimination | Popular, Inc. |
| :--- | :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Holding Co. | Co. | Holding Co. | eliminations | entries | Consolidated |

## ASSETS

Cash and due from

| banks | $\$$ | 1,391 | $\$$ | 376 | $\$$ | 400 | $\$$ | 818,455 | $\$$ | $(1,797)$ | $\$$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Money market <br> investments | 46,400 |  | 300 |  | 151 | $1,083,212$ | $(123,351)$ | $1,006,712$ |  |  |  |
| Trading account <br> securities, at fair value |  |  |  |  |  | 768,274 |  | $(319)$ | 767,955 |  |  |
| Investment securities <br> available-for-sale, at <br> fair value |  |  | 31,705 |  | $8,483,430$ |  |  | $8,515,135$ |  |  |  |
| Investment securities <br> held-to-maturity, at <br> amortized cost |  |  |  |  |  |  |  |  |  |  |  |

Other investment securities, at lower of cost or realizable value 14,425

12,392
189,766
216,584
Investment in subsidiaries
$2,817,934 \quad 648,720 \quad 1,717,823$
$(5,184,477)$
Loans held-for-sale measured at lower of cost or market value

| Loans held-in-portfolio | 725,426 | 25,150 | $2,978,528$ | $28,282,440$ | $(3,807,978)$ | $28,203,566$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Less Unearned income <br> Allowance for loan <br> losses |  |  |  | 182,110 |  | 182,110 |
|  | 60 |  |  | 548,772 |  | 548,832 |
|  | 725,366 | 25,150 | $2,978,528$ | $27,551,558$ | $(3,807,978)$ | $27,472,624$ |

Premises and

| equipment, net | 23,772 |  | 131 | 564,260 |  |
| :--- | :---: | ---: | ---: | ---: | ---: |
| Other real estate |  |  |  | 81,410 |  |
| Accrued income |  |  |  |  | 588,163 |
| receivable | 1,675 | 62 | 14,271 | 215,719 | $(15,613)$ |
| Servicing assets |  |  |  | 196,645 | 216,114 |
| Other assets | 40,740 | 60,814 | 47,210 | $1,336,674$ | $(28,444)$ |
| Goodwill |  |  |  | 630,761 | $1,456,994$ |
| Other intangible assets | 554 |  |  | 68,949 |  |
|  |  |  |  | 630,761 |  |
|  |  |  |  |  | 69,503 |

Edgar Filing: POPULAR INC - Form 10-Q
$\$ 4,298,386 \quad \$ 768,378 \quad \$ 4,770,906 \quad \$ 44,165,746 \quad \$(9,591,979) \quad \$ 44,411,437$

## LIABILITIES AND

STOCKHOLDERS EQUITY
Liabilities:
Deposits:
Non-interest bearing
Interest bearing

Federal funds purchased and assets sold under agreements

| to repurchase |  |  |  |  | $\$ 168,892$ | $5,391,273$ | $(122,900)$ | $5,437,265$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Other short-term |  |  |  |  | $1,055,773$ | $1,707,184$ | $(1,525,978)$ | $1,501,979$ |
| borrowings | $\$$ | 165,000 |  |  | 1,159 |  |  |  |
| Notes payable | 480,117 |  |  | $2,754,339$ | $3,669,216$ | $(2,282,320)$ | $4,621,352$ |  |
| Subordinated notes |  |  |  |  |  | 430,000 | $(430,000)$ |  |
| Other liabilities | 71,387 | $\$$ | 116 | 62,059 | 843,892 | $(43,082)$ | 934,372 |  |
|  | 716,504 |  | 116 | $4,141,063$ | $40,378,232$ | $(4,406,469)$ | $40,829,446$ |  |

Minority interest in consolidated subsidiaries

Stockholders equity:
Preferred stock
Common stock
Surplus
Retained earnings
Treasury stock, at cost

| 186,875 |  |  |  |  | 186,875 |
| ---: | ---: | ---: | ---: | ---: | ---: |
| $1,761,908$ | 3,961 | 2 | 51,619 | $(55,582)$ | $1,761,908$ |
| 563,183 | 851,193 | 734,964 | $2,709,595$ | $(4,290,751)$ | 568,184 |
| $1,324,468$ | $(46,897)$ | $(99,806)$ | $1,037,153$ | $(895,451)$ | $1,319,467$ |
| $(207,740)$ |  |  | $(664)$ | 664 | $(207,740)$ |
|  |  |  |  |  |  |
| $(46,812)$ | $(39,995)$ | $(5,317)$ | $(10,298)$ | 55,610 | $(46,812)$ |
|  |  |  |  |  |  |
| $3,581,882$ | 768,262 | 629,843 | $3,787,405$ | $(5,185,510)$ | $3,581,882$ |
|  |  |  |  |  |  |
| $\$ 4,298,386$ | $\$ 768,378$ | $\$ 4,770,906$ | $\$ 44,165,746$ | $\$(9,591,979)$ | $\$ 44,411,437$ |

## Table of Contents

## POPULAR, INC.

CONDENSED CONSOLIDATING STATEMENT OF CONDITION
JUNE 30, 2007
(UNAUDITED)

|  | Popular, Inc. | PIBI | PNA | All other <br> subsidiaries <br> and | Elimination | Popular, Inc. |
| :--- | :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Holding Co. | Holding Co. | Holding Co. | eliminations | entries | Consolidated |

## ASSETS

Cash and due from

| banks | $\$$ | 1,775 | $\$$ | 317 | $\$$ | 377 | $\$$ | 761,533 | $\$$ | $(1,917)$ | $\$$ | 762,085 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Money market <br> investments |  |  |  | 19,025 |  | 212 |  | 632,987 |  | $(77,237)$ |  | 574,987 |

Investment securities available-for-sale, at fair value
Investment securities held-to-maturity, at amortized cost
Other investment securities, at lower of cost or realizable value
Trading account securities, at fair value $\quad 676,923 \quad$ (65) 676,858 Investment in subsidiaries

3,144,484 1,052,636 1,995,552
Loans held-for-sale measured at lower of
$\left.\begin{array}{lrrrrr}\text { cost or market value } & & & 605,990 & & 605,990 \\ \text { Loans held-in-portfolio } & 340,197 & & & & \\ \begin{array}{l}\text { Less Unearned income } \\ \text { Allowance for loan } \\ \text { losses }\end{array} & 40 & & 358,637 & 32,454,522 & (3,283,637)\end{array}\right) 32,469,719$

| Premises and equipment, net | 24,891 |  | 133 | 562,481 |  | 587,505 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Other real estate |  |  |  | 112,858 |  | 112,858 |
| Accrued income receivable | 446 | 110 | 12,473 | 249,104 | $(12,387)$ | 249,746 |
| Servicing assets |  |  |  | 201,861 |  | 201,861 |
| Other assets | 42,239 | 59,686 | 53,233 | 1,199,718 | $(57,276)$ | 1,297,600 |
| Goodwill |  |  |  | 668,469 |  | 668,469 |
| Other intangible assets | 554 |  |  | 101,745 |  | 102,299 |

Edgar Filing: POPULAR INC - Form 10-Q
\$4,245,661 \$1,169,537 \$5,033,009 \$46,601,197 \$(10,064,041) \$46,985,363

## LIABILITIES AND STOCKHOLDERS EQUITY

## Liabilities:

Deposits:
Non-interest bearing
Interest bearing

Federal funds purchased and assets

| to repurchase $\quad \$ 153,952$ 5,559,984 ${ }^{\text {a }}$ (58,000) 5,655,936 |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Other short-term |  |  |  |  |  |  |  |  |  |
| borrowings |  |  |  |  |  | 857,763 | 4,018,829 | $(1,492,487)$ | 3,384,105 |
| Notes payable | \$ | 486,479 |  |  |  | 2,890,535 | 6,491,688 | $(1,800,064)$ | 8,068,638 |
| Subordinated notes |  |  |  |  |  |  | 430,000 | $(430,000)$ |  |
| Other liabilities |  | 62,102 | \$ | 66 |  | 94,464 | 705,236 | $(68,368)$ | 793,500 |
|  |  | 548,581 |  | 66 |  | 3,996,714 | 42,612,827 | (3,870,014) | 43,288,174 |

Minority interest in consolidated subsidiaries

Stockholders equity: Preferred stock
Common stock
Surplus
Retained earnings
Accumulated other
comprehensive loss, net of tax
Treasury stock, at cost

| 186,875 |  |  |  |  | 186,875 |
| ---: | ---: | ---: | ---: | ---: | ---: |
| $1,756,337$ | 3,961 | 2 | 51,619 | $(55,582)$ | $1,756,337$ |
| 528,151 | 851,193 | 734,964 | $2,571,295$ | $(4,152,451)$ | 533,152 |
| $1,706,101$ | 380,548 | 323,165 | $1,601,501$ | $(2,310,215)$ | $1,701,100$ |
|  |  |  |  |  |  |
| $(274,817)$ | $(66,231)$ | $(21,836)$ | $(235,490)$ | 323,557 | $(274,817)$ |
| $(205,567)$ |  |  | $(664)$ | 664 | $(205,567)$ |
| $3,697,080$ | $1,169,471$ | $1,036,295$ | $3,988,261$ | $(6,194,027)$ | $3,697,080$ |
|  |  |  |  |  |  |
| $\$ 4,245,661$ | $\$ 1,169,537$ | $\$ 5,033,009$ | $\$ 46,601,197$ | $\$(10,064,041)$ | $\$ 46,985,363$ |

## Table of Contents

POPULAR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
FOR THE QUARTER ENDED JUNE 30, 2008 (UNAUDITED)


INTEREST
EXPENSE:

| Deposits |  |  | 168,343 | $(298)$ | 168,045 |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Short-term borrowings | 589 | 4,520 | 44,967 | $(7,574)$ | 42,502 |
| Long-term debt | 8,283 | 30,483 | 42,346 | $(29,389)$ | 51,723 |
|  | 8,872 | 35,003 | 255,656 | $(37,261)$ | 262,270 |

Net interest income
(loss)

Provision for loan losses

49,846
615
$(11,262)$
343,387 $\quad(44,701) \quad 337,885$
losses
Net interest income (loss) after provision for loan losses
Service charges on deposit accounts
Other service fees
Net gain on sale and valuation adjustments of investment securities 27,763

27,763
Trading account profit
16,711
16,711
$(35,922)$
$(35,922)$

Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159
Loss on sale of loans and valuation adjustments on loans held-for-sale Other operating (loss) income


OPERATING
EXPENSES:
Personnel costs:

| Salaries | 5,909 | 106 |  | 121,182 | $(1,774)$ | 125,423 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Pension, profit sharing and other benefits | 1,414 | 19 |  | 35,039 | (10) | 36,462 |
|  | 7,323 | 125 |  | 156,221 | $(1,784)$ | 161,885 |
| Net occupancy expenses | 614 | 8 | 1 | 25,739 |  | 26,362 |
| Equipment expenses | 892 |  |  | 29,832 |  | 30,724 |
| Other taxes | 461 |  |  | 13,418 |  | 13,879 |
| Professional fees | 3,289 | 2 | 90 | 29,679 | $(1,433)$ | 31,627 |
| Communications | 73 | 4 | 9 | 13,059 |  | 13,145 |
| Business promotion | 482 |  |  | 17,769 |  | 18,251 |
| Printing and supplies | 19 |  |  | 3,880 |  | 3,899 |
| Other operating expenses | $(12,683)$ | (101) | 68 | 58,570 | (383) | 45,471 |
| Amortization of intangibles |  |  |  | 2,490 |  | 2,490 |
|  | 470 | 38 | 168 | 350,657 | $(3,600)$ | 347,733 |

Income (loss) before income tax and equity in losses of subsidiaries
Income tax benefit
49,300
4,181
$(13,475)$
1,649
$(48,571)$
87
$(6,916)$
$(31,166)$
Income (loss) before equity in losses of subsidiaries
Equity in undistributed losses of subsidiaries 50,303 4,181
$(26,053)$
$(76,247) \quad(70,488)$
27,178
$(48,658)$
24,250

NET INCOME
(LOSS)
\$ 24,250
$\$(72,066) \quad \$(79,242) \quad \$ 27,178$
\$124,130
\$ 24,250

## Table of Contents

POPULAR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
FOR THE QUARTER ENDED JUNE 30, 2007 (UNAUDITED)

|  | Popular, |  |  | All other |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Inc. | PIBI | PNA | subsidiaries | Elimination | Popular, Inc. |  |
| (In thousands) | Holding Co. | Holding | Co. | Holding Co. | eliminations | entries | Consolidated |

## INTEREST AND

DIVIDEND
INCOME:
Dividend income from
subsidiaries $\quad \$ 44,700$
Loans 4,158

Money market investments
Investment securities
793

Trading account securities

$$
\begin{array}{lll}
59,199 & 919 & 38,653
\end{array}
$$

9,611
9,611

INTEREST
EXPENSE:
Deposits
Short-term borrowings 78
Long-term debt

Net interest income (loss)
Provision for loan losses

50,755
919
$(12,798)$
376,942
$(44,401) \quad 371,417$
losses
Net interest income (loss) after provision for loan losses

50,755
919
$(12,798) \quad 261,775$
$(44,401)$
256,250
Service charges on
deposit accounts
48,392
48,392
Other service fees
91,163
$(1,573)$
89,590
Net (loss) gain on sale
and valuation
adjustments of
investment securities
$(2,132) \quad(907)$
4,214
1,175
Trading account gain

Gain on sale of loans and valuation adjustment on loans held-for-sale
Other operating income (loss)

OPERATING
EXPENSES:
Personnel costs:
Salaries
Pension, profit sharing

|  |  |  | 28,294 | 28,294 |  |
| ---: | ---: | ---: | ---: | ---: | ---: |
| 529 | 1,201 | $(102)$ | 24,640 | $(721)$ | 25,547 |
| 49,152 | 1,213 | $(12,900)$ | 468,855 | $(46,695)$ | 459,625 |

and other benefits
Net occupancy
expenses
Equipment expenses
Other taxes 335
Professional fees
Communications 3,295 136
Business promotion
Printing and supplies
Other operating expenses
Amortization of intangibles
$35131 \quad 175 \quad 362,328 \quad(1,832) \quad 361,053$

Income (loss) before income tax and equity in earnings (losses) of subsidiaries
Income tax expense (benefit)

Income (loss) before equity in earnings (losses) of subsidiaries Equity in undistributed earnings (losses) of subsidiaries

NET INCOME
(LOSS) \$ 74,950 \$(6,744) \$ $(8,642) \quad \$ 79,657 \quad \$(64,271) \quad \$ 74,950$

## Table of Contents

POPULAR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
FOR THE SIX MONTHS ENDED JUNE 30, 2008 (UNAUDITED)

|  | Popular, |  |  | All other |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Inc. | PIBI | PNA | subsidiaries | Elimination | Popular, Inc. |  |
| (In thousands) | Holding Co. | Holding | Co. | Holding | Co. | eliminations | entries | Consolidated

## INTEREST AND <br> DIVIDEND

INCOME:
Dividend income from subsidiaries Loans
Money market investments Investment securities
\$ 89,900
12,773 \$ 219
\$ 58,592
557
16,076
Trading account securities

$$
\begin{array}{llll}
119,306 & 1,256 & 59,234 & 1,279,185
\end{array}
$$

INTEREST
EXPENSE:
Deposits
Short-term borrowings
2,609
16,567
19,176

Net interest income (loss)
Provision for loan losses

$$
100,130
$$

1,256
$(22,174)$
705,164
358,822
$(89,302)$
695,074
40
Net interest income (loss) after provision for loan losses
Service charges on deposit accounts 100,090

1,256
$(22,174)$
346,342
$(89,302)$
336,212

Other service fees
Net gain on sale and valuation adjustments of investment
securities
75,703
75,703
Trading account profit
Table of Contents

Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 Gain on sale of loans and valuation adjustments on loans held-for-sale Other operating (loss) income

OPERATING
EXPENSES:
Personnel costs:

Income (loss) before income tax and equity in earnings (losses) of subsidiaries
Income tax expense (benefit)

Income (loss) before equity in earnings (losses) of subsidiaries Equity in undistributed earnings (losses) of subsidiaries

$$
28,739
$$

$(78,589) \quad(71,060)$

| Salaries <br> Pension, profit sharing and other benefits | 11,993 | 197 |  | 251,951 | $(2,009)$ | 262,132 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2,923 | 42 |  | 72,039 | (72) | 74,932 |
|  | 14,916 | 239 |  | 323,990 | $(2,081)$ | 337,064 |
| Net occupancy |  |  |  |  |  |  |
| Equipment expenses | 1,741 |  |  | 60,981 |  | 62,722 |
| Other taxes | 900 |  |  | 26,122 |  | 27,022 |
| Professional fees | 7,445 | 5 | 180 | 63,304 | $(2,682)$ | 68,252 |
| Communications | 195 | 9 | 18 | 28,226 |  | 28,448 |
| Business promotion | 771 |  |  | 34,696 |  | 35,467 |
| Printing and supplies | 42 |  |  | 8,132 |  | 8,174 |
| Other operating expenses | $(26,740)$ | (201) | 121 | 114,415 | (832) | 86,763 |
| Amortization of intangibles |  |  |  | 4,982 |  | 4,982 |
|  | 513 | 67 | 321 | 724,942 | $(5,595)$ | 720,248 |

$(38,942)$
$(38,942)$

67,292

| $(111)$ | 7,154 | $(2,041)$ | 54,779 | $(1,894)$ | 57,887 |
| ---: | ---: | ---: | ---: | ---: | ---: |
| 99,979 | 8,410 | $(24,215)$ | 851,903 | $(98,318)$ | 837,759 |

126,961 $(92,723)$

117,511
665
$(8,372)$
$(2,701)$
379
$(10,029)$
$\begin{array}{lllll}98,801 & 8,343 & (16,164) & 129,662 & (93,102)\end{array}$

Edgar Filing: POPULAR INC - Form 10-Q
NET INCOME
(LOSS) $\quad \$ 127,540 \quad \$(70,246) \quad \$(87,224) \quad \$ 129,662 \quad \$ 27,808 \quad \$ 127,540$

## Table of Contents

POPULAR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
FOR THE SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)

|  | Popular, |  |  | All other |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Inc. | PIBI | PNA | subsidiaries | Elimination | Popular, Inc. |
| (In thousands) | Holding Co. | Holding | Co. | Holding Co. | eliminations | entries | Consolidated

## INTEREST AND <br> DIVIDEND

INCOME:
Dividend income from
subsidiaries $\$ 89,400$

Loans
Money market investments
Investment securities
Trading account securities
$117,242 \quad 1,311 \quad 76,632 \quad 1,555,187 \quad(191,866) \quad 1,558,506$

## INTEREST

EXPENSE:
Deposits
Short-term borrowings

|  |  | 356,739 | $(907)$ | 355,832 |
| ---: | ---: | ---: | ---: | ---: |
| 1,965 | 28,886 | 254,481 | $(41,057)$ | 244,275 |
| 16,732 | 73,885 | 202,488 | $(61,105)$ | 232,000 |
| 18,697 |  |  |  |  |
|  | 102,771 | 813,708 | $(103,069)$ | 832,107 |

Net interest income
(loss)

Provision for loan losses

98,545
1,311
$(26,139)$
741,479
$(88,797)$
726,399
7
211,506
211,513

Net interest income (loss) after provision for loan losses
Service charges on deposit accounts

98,538
1,311
$(26,139)$
529,973
$(88,797)$
514,886

Other service fees
96,863
$(2,272)$
96,863
Net gain (loss) on sale
and valuation
adjustments of
investment securities
$116,592 \quad(8,507)$
$(25,139)$
82,946
Trading account loss $(3,787)$
Table of Contents

Gain on sale of loans and valuation adjustment on loans held-for-sale
Other operating income (loss)

## OPERATING

EXPENSES:
Personnel costs:
Salaries
Pension, profit sharing

|  |  | 31,728 | 31,728 |  |  |
| ---: | ---: | ---: | ---: | ---: | ---: |
| 9,762 | 11,210 | $(629)$ | 51,268 | $(1,249)$ | 70,362 |
| 224,892 | 4,014 | $(26,768)$ | 860,617 | $(92,318)$ | 970,437 |

## Table of Contents

## POPULAR, INC.

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS FOR THE SIX MONTHS ENDED JUNE 30, 2008 (UNAUDITED)

|  | Popular, Inc. | Holding | PNA | All other <br> subsidiaries <br> and | Elimination | Popular, Inc. |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Holding Co. | Co. | Holding Co. | eliminations | entries | Consolidated |

Cash flows from operating activities:
Net income (loss)
\$ $127,540 \quad \$(70,246) \quad \$(87,224) \quad \$ 129,662 \quad \$ \quad 27,808 \quad \$ \quad 127,540$

Adjustments to reconcile net income to net cash provided by (used in) operating activities:
Equity in undistributed (earnings) losses of subsidiaries Depreciation and amortization of premises and equipment Provision for loan losses
Amortization of intangibles Amortization and fair value adjustment of servicing assets
Net gain on sale and valuation adjustment of investment securities $(28,739) \quad 78,589 \quad 71,060$ $(120,910)$ Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 38,94238,942

Net loss (gain) on disposition of premises and equipment 57 $(75,703)$

Net gain on sale of loans and valuation adjustments on loans held-for-sale

Net amortization of premiums and accretion of discounts on investments Net amortization of premiums and deferred loan origination fees and costs
Losses (earnings) from investments under the
equity method
Stock options expense
Deferred income taxes
111
239
(170)

Net disbursements on loans held-for-sale Acquisitions of loans held-for-sale
Proceeds from sale of loans held-for-sale Net decrease in trading securities
Net decrease (increase) in accrued income receivable
Net decrease (increase) in other assets
Net decrease in interest payable Net increase in postretirement benefit obligation
Net
(decrease) increase in other liabilities

Total adjustments
Net cash provided by (used in) operating activities

## Cash flows from

 investing activities:Net
(increase) decrease in money market investments
Purchases of investment securities:
Available-for-sale
28,951

$$
28,951
$$559

$(83,836)$
$(1,509,819)$
$(185,053)$
1,006,208
732,067

42,301
(264,170)
$(53,440)$

$$
203
$$

| $(1,970)$ | $(24)$ | 14,972 | $(22,046)$ | $(15,361)$ | $(24,429)$ |
| ---: | ---: | ---: | :---: | ---: | :---: |
| $(27,658)$ | 75,290 | 51,302 | 36,816 | $(121,331)$ | 14,419 |


| 99,882 | 5,044 | $(35,922)$ | 166,478 | $(93,523)$ | 141,959 |
| :--- | :--- | :--- | :--- | :--- | :--- |

Held-to-maturity
$(497,750)$
Other
Proceeds from calls, paydowns, maturities and redemptions of investment securities:
Available-for-sale
Held-to-maturity
Other
Proceeds from sale of investment securities available-for-sale
Proceeds from sale of other investment
securities
Net (disbursements) repayments on loans Proceeds from sale of loans
Acquisition of loan portfolios
Capital contribution to subsidiary
Mortgage servicing rights purchased
Acquisition of premises and equipment
Proceeds from sale of premises and equipment
Proceeds from sale of foreclosed assets

Net cash (used in) provided by investing activities

## Cash flows from

financing activities:
Net decrease in deposits
Net increase (decrease) in federal funds purchased and assets sold under agreements to repurchase
Net
(decrease) increase in other short-term
(118)
$(3,133,391)$
$(136,775)$
$(3,631,141)$
$(136,775)$

1,851,899
1,851,899
3,215,838 3,884,838
112,628
112,628

2,398,208 2,406,504

49,330 49,330
$(14,020) \quad 25,150 \quad(515,568) \quad(1,207,321,431) \quad(596,548)$
$1,715,330 \quad 1,715,330$
$(6,669)$
$(6,669)$
1,512
$(2,986)$
$(2,986)$
$(97,910)$
$(98,028)$

19,743
19,743
51,684
51,684
$(233,200) \quad(5,135) \quad 1,207,265 \quad 2,279,298 \quad(947,163) \quad 2,301,065$

Edgar Filing: POPULAR INC - Form 10-Q
borrowings
Payments of notes

| payable <br> Proceeds from <br> issuance of notes | (549,745) | $(1,393,747)$ | 699,818 | $(1,243,674)$ |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
| payable | 198 | 7,621 | 624,367 | $(2,000)$ | 630,186 |
| Dividends paid to <br> parent company <br> Dividends paid |  |  | $(89,900)$ | 89,900 |  |

## Table of Contents

|  |  | PIBI |  | All other |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Popular, Inc. <br> Holding Co. | Holding Co. | PNA $c_{\text {PN }}^{\text {Holding Co. }}$ | subsidiaries and eliminations | Elimination <br> entries | Popular, Inc. <br> Consolidated |
| Proceeds from issuance of common stock | 10,120 |  |  |  |  | 10,120 |
| Proceeds from issuance of preferred stock | 386,257 |  |  |  | 3,793 | 390,050 |
| Treasury stock acquired | (59) |  |  | (299) |  | (358) |
| Capital contribution from parent |  |  |  | 1,500 | $(1,500)$ |  |
| Net cash provided by (used in) financing activities | 132,831 |  | $(1,164,097)$ | (2,384,338) | 1,041,374 | (2,374,230) |
| Net (decrease) increase in cash and due from banks | (487) | (91) | 7,246 | 61,438 | 688 | 68,794 |
| Cash and due from banks at beginning of period | 1,391 | 376 | 400 | 818,455 | $(1,797)$ | 818,825 |
| Cash and due from banks at end of period | \$ 904 | \$285 | \$ 7,646 | \$ 879,893 | $(\$ 1,109)$ | \$ 887,619 |

## Table of Contents

POPULAR, INC.
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)

|  | Popular, Inc. | PIBI | PNA | All other <br> subsidiaries <br> and | Elimination | Popular, Inc. |  |
| :--- | :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Holding Co. | Holding | Co. | Holding | Co. | eliminations | entries | Consolidated

Cash flows from operating activities: Net income (loss) $\begin{array}{llllllll}\$ & 193,597 & \$(78,968) & \$(84,241) & \$ & 100,523 & \$ 62,686 & \$ \\ 193,597\end{array}$

Adjustments to reconcile net income to net cash provided by (used in) operating activities:
Equity in undistributed losses of subsidiaries
Depreciation and amortization of premises and equipment
Provision for loan losses
Amortization of intangibles $2,258 \quad 82,917 \quad 66,609$
$(151,784)$

Amortization and fair value adjustments of servicing assets

1,180
2
38,791
39,973

Net (gain) loss on sale and valuation
adjustment of investment securities Net gain on disposition of premises and equipment
$(116,592)$
8,507
25,139
$(82,946)$

Net gain on sale of loans and valuation adjustments on loans held-for-sale $(31,728)$
Net amortization of premiums and accretion of discounts on investments $(2,665)$ 6 13,894 11,235
Net amortization of premiums and deferred
loan origination fees and costs
(Earnings) losses from investments under the equity method
Stock options expense
Deferred income taxes
Net disbursements on loans held-for-sale
Acquisitions of loans held-for-sale $(4,515)$ 364
1,470
$(11,210)$
629
$(682)$
543
(812)
$(16,590)$
907
$(56,613) \quad 16,525$
$(48,112)$

Proceeds from sale of loans held-for-sale
Net decrease in trading securities
Net decrease (increase) in accrued income receivable
Net decrease (increase) in other assets
Net increase (decrease) in interest payable

130
Net increase in postretirement benefit obligation

613
(98)
(893)
$(1,463)$ 335
$\begin{array}{rrr}2,833,030 & & 2,833,030 \\ 645,616 & 64 & 645,680\end{array}$

Net increase
(decrease) in other liabilities

Total adjustments 3,108
$(91,321)$
82,669
70,227
152,057 (152,023)
$(52,071)$

Net cash provided by (used in) operating activities

102,276
Cash flows from investing activities:
Net decrease
(increase) in money market investments
Purchases of investment securities:
Available-for-sale
Held-to-maturity
$(6,808)$
$(1,215,671)$
Other
Proceeds from calls, paydowns, maturities
and redemptions of investment securities:

| Available-for-sale |  |  |  | 1,267,162 | $(456,452)$ | 810,710 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Held-to-maturity | 978,000 | 400 |  | 10,979,564 |  | 11,957,964 |
| Other |  |  |  | 5,445 |  | 5,445 |
| Proceeds from sale of investment securities |  |  |  |  |  |  |
| available-for-sale |  | 14,009 |  | 14,972 |  | 28,981 |
| Proceeds from sale of other investment securities | 245,484 | 2 | 865 | 1 |  | 246,352 |
| Net repayments (disbursements) on |  |  |  |  |  |  |
| loans | 127,445 |  | (78) | $(359,059)$ | $(130,877)$ | $(362,569)$ |
| Proceeds from sale of loans |  |  |  | 3,549 |  | 3,549 |
| Acquisition of loan portfolios |  |  |  | (784) |  | (784) |
| Capital contribution to subsidiary |  |  |  | 500 | (500) |  |
| Assets acquired, net of cash |  |  |  | $(1,633)$ |  | $(1,633)$ |
| Mortgage servicing rights purchased |  |  |  | $(23,988)$ |  | $(23,988)$ |
| Acquisition of premises and equipment | (445) |  |  | $(49,207)$ |  | $(49,652)$ |
| Proceeds from sale of premises and equipment |  |  |  | 21,951 |  | 21,951 |
| Proceeds from sale of foreclosed assets |  |  |  | 80,278 |  | 80,278 |
| Net cash provided by (used in) investing activities | 136,705 | $(3,541)$ | 2,200 | 110,061 | $(111,595)$ | 133,830 |
| Cash flows from financing activities: |  |  |  |  |  |  |
| Net increase in deposits |  |  |  | 954,144 | $(17,334)$ | 936,810 |
| Net decrease in federal funds purchased and assets sold under agreements to repurchase |  |  | $(5,877)$ | $(102,132)$ | 1,500 | $(106,509)$ |
| Net decrease in other short-term borrowings | $(150,787)$ |  | $(37,195)$ | $(384,474)$ | $(77,564)$ | $(650,020)$ |
| Payments of notes payable |  |  | $(3,920)$ | $(972,515)$ | 202,704 | $(773,731)$ |
| Proceeds from issuance of notes payable | 198 |  | 58,861 | 44,190 |  | 103,249 |

Dividends paid to parent company $(89,400) \quad 89,400$

## Table of Contents

| (In thousands) | Popular, Inc. <br> Holding Co. | PIBI Holding Co. | PNA Holding Co. | All other subsidiaries and eliminations | Elimination entries | Popular, Inc. <br> Consolidated |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Dividends paid | $(95,223)$ |  |  |  |  | $(95,223)$ |
| Proceeds from issuance of common stock | 8,667 |  |  |  |  | 8,667 |
| Treasury stock acquired | (63) |  |  | (289) |  | (352) |
| Capital contribution from parent |  |  |  |  | 500 |  |
| Net cash (used in) provided by financing activities | $(237,208)$ |  | 11,869 | $(550,976)$ | 199,206 | $(577,109)$ |
| Net increase (decrease) in cash and due from banks | 1,773 | 160 | 55 | $(188,335)$ | $(1,726)$ | $(188,073)$ |
| Cash and due from banks at beginning of period | 2 | 157 | 322 | 949,868 | (191) | 950,158 |
| Cash and due from banks at end of period | \$ 1,775 | \$317 | \$ 377 | \$ 761,533 | \$ (1,917) | \$ 762,085 |
|  |  |  |  |  |  | 69 |

## Table of Contents

## ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This report includes management s discussion and analysis ( MD\&A ) of the consolidated financial position and financial performance of Popular, Inc. and its subsidiaries (the Corporation or Popular ). All accompanying tables, financial statements and notes included elsewhere in this report should be considered an integral part of this analysis.

## OVERVIEW

Popular, Inc. (the Corporation or Popular ) is a diversified, publicly owned financial holding company subject to the supervision and regulation of the Board of Governors of the Federal Reserve System. The Corporation is a full service financial services provider with operations in Puerto Rico, the United States, the Caribbean and Latin America. As the leading financial institution in Puerto Rico, the Corporation offers retail and commercial banking services through its principal banking subsidiary, Banco Popular de Puerto Rico ( BPPR ), as well as auto and equipment leasing and financing, mortgage loans, consumer lending, investment banking, broker-dealer and insurance services through specialized subsidiaries. In the United States, the Corporation operates Banco Popular North America ( BPNA ), including its wholly-owned subsidiary E-LOAN, and Popular Financial Holdings ( PFH ). BPNA is a community bank providing a broad range of financial services and products to the communities it serves. BPNA operates branches in New York, California, Illinois, New Jersey, Florida and Texas. E-LOAN offers online consumer direct lending and provides an online platform to raise deposits for BPNA. As described in Note 19 to the consolidated financial statements, E-LOAN restructured its business operations during the fourth quarter of 2007 and the beginning of 2008. PFH, after certain restructuring events discussed also in Note 19 to the consolidated financial statements, exited the branch network loan origination business during the first quarter of 2008, but continues to operate a mortgage loan servicing unit, a small scale origination / refinancing unit and to carry a maturing loan portfolio. The Corporation, through its transaction processing company, EVERTEC, continues to use its expertise in technology as a competitive advantage in its expansion throughout the United States, the Caribbean and Latin America, as well as internally servicing many of its subsidiaries system infrastructures and transactional processing businesses. Note 24 to the consolidated financial statements presents further information about the Corporation s business segments. The Corporation reported net income for the quarter ended June 30, 2008 of $\$ 24.3$ million, compared with $\$ 75.0$ million in the same quarter of 2007. Table A provides selected financial data and performance indicators for the quarter and six-month periods ended June 30, 2008 and 2007.
During the second quarter of 2008, the Corporation continued to feel the pressure of the turmoil in the financial markets and deteriorating economic conditions. Management is actively engaged in the process of evaluating various strategic alternatives to improve the profitability of the Corporation s operations in the United States and to improve the Corporation s liquidity. Some of these alternatives may involve further restructurings and the sale of some or all of these operations or their assets. As a result of the current lack of liquidity in the credit markets, certain recent sales of portfolios of mortgages or mortgage related assets by other institutions have been executed at prices below the carrying value of those assets. If we were to execute a sale of some of our operations or their assets at a similar discounted price, such a sale would result in a loss on their disposition, which may be significant. In addition, restructurings or asset sales may require the Corporation to recognize a valuation allowance against its deferred tax assets, resulting in further losses.
Our banking and processing businesses in Puerto Rico continue to perform well despite a weak economy. Banco Popular de Puerto Rico met management sexpectations for the first half of the year with that segment reporting net income amounting to $\$ 191.3$ million even with significant increases in its provision for loan losses. In addition, the Corporation remains well capitalized with over $\$ 1$ billion of Tier I capital in excess of the regulatory well capitalized requirement.
Financial results for the quarter ended June 30, 2008 were principally impacted by the following items (on a pre-tax basis compared to the second quarter of 2007):

## Table of Contents

Lower net interest income on a taxable equivalent basis by $\$ 34.3$ million mainly due to the sale and reduction of various low margin assets.

Higher provision for loan losses for the second quarter of 2008, which increased by $\$ 75.5$ million as compared with the same period in 2007, driven principally by higher net charge-offs, and deteriorating credit quality trends, primarily in the U.S. mainland consumer loan portfolio, and in the Corporation s commercial and construction loan portfolios. Details on credit quality indicators are included in the Credit Risk Management and Loan Quality Section in this MD\&A.

Net losses attributable to changes in the fair value of Popular Financial Holdings ( PFH ) loans and bond certificates measured at fair value pursuant to SFAS No. 159 amounted to $\$ 35.9$ million for the quarter ended June 30, 2008.

Lower net gain on sale of loans and valuation adjustments on loans held-for-sale by $\$ 29.7$ million for the second quarter of 2008, with PFH and E-LOAN showing a reduction of approximately $\$ 34$ million.
The above were partially offset by:
Higher combined net gains on sale and valuation adjustments of investment securities and trading account profits by $\$ 32.9$ million, primarily resulting from sales of agency securities and a higher volume of mortgage loans pooled and sold as mortgage-backed securities in the secondary markets in the Banco Popular de Puerto Rico reportable segment. Refer to Balance Sheet comments for further information.

Higher other non-interest income by $\$ 22.9$ million.
Lower operating expenses by $\$ 13.3$ million.
Income tax benefit of $\$ 31.2$ million for the second quarter of 2008, compared with income tax expense of $\$ 23.6$ million for the same quarter in 2007.
During the second quarter of 2008, the Corporation successfully completed the public offering of $\$ 400$ million of $8.25 \%$ Non-cumulative Monthly Income Preferred Stock, Series B, which qualifies in its entirety as Tier I capital for risk-based capital ratios. The offering, which was oversubscribed, was priced at $\$ 25$ per share. The preferred stock issue was completely sold in Puerto Rico. Net proceeds will be used for general corporate purposes, including funding subsidiaries and increasing Popular s liquidity and capital.
Specific significant events that occurred in the first quarter ended March 31, 2008 were also important in evaluating the Corporation s financial performance for the six months ended June 30, 2008, which included:

The sale of certain assets of Equity One, a subsidiary of PFH, to American General Financial ( American General ), a member of American International Group. As part of the transaction, American General acquired approximately $\$ 1.4$ billion of mortgage and consumer loans and retained some of Equity One s branch locations. The gain on sale and valuation adjustments of these loans approximated $\$ 47.4$ million for the six-month period ended June 30, 2008. This sale transaction also led to branch closures as part of the PFH Branch Network Restructuring Plan during the first quarter of 2008. This plan resulted in charges for the Corporation of approximately $\$ 16.6$ million for the six-month period ended June 30, 2008. Refer to the Restructuring Plans section of this MD\&A for further information.

The sale of six retail bank branches of BPNA in Houston, Texas to Prosperity Bank. The Corporation realized a gain of approximately $\$ 12.8$ million in the first quarter of 2008 related with this transaction. BPNA will continue to operate its mortgage business based in Houston as well as its franchise and small business lending activities in Texas. BPNA will also continue to maintain a retail branch in Arlington, Texas.

Gain of $\$ 49.3$ million in the first quarter of 2008 resulting from the mandatory partial redemption of Visa stock as a result of Visa s initial public offering. After the mandatory partial redemption of Visa stock, the Corporation continues to hold 883,435 Class C (Series I) and 21,454 Class B unredeemed shares of Visa stock with a book value of zero as of June 30, 2008. No gains will be recognized on the unredeemed stock until such time they are redeemed for cash or sold.

TABLE A
Financial Highlights

## Financial Condition Highlights

| (In thousands) | At June 30, |  |  | Average for the six months |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | Variance | 2008 | 2007 | Variance |
| Money market investments | \$ 897,796 | \$ 574,987 | \$ 322,809 | \$ 677,101 | \$ 404,686 | \$ 272,415 |
| Investment and trading securities | 8,675,029 | 10,240,955 | $(1,565,926)$ | 9,093,840 | 10,785,609 | $(1,691,769)$ |
| Loans | 27,631,678 | 32,751,845 | $(5,120,167)$ | 28,299,865 | 32,712,076 | $(4,412,211)$ |
| Total earning assets | 37,204,503 | 43,567,787 | $(6,363,284)$ | 38,070,806 | 43,902,371 | $(5,831,565)$ |
| Total assets | 41,678,594 | 46,985,363 | $(5,306,769)$ | 41,774,824 | 47,224,603 | $(5,449,779)$ |
| Deposits | 27,115,728 | 25,385,995 | 1,729,733 | 27,275,700 | 24,630,221 | 2,645,479 |
| Borrowings | 10,000,259 | 17,108,679 | $(7,108,420)$ | 10,217,503 | 17,940,022 | $(7,722,519)$ |
| Stockholders equity | 3,705,994 | 3,697,080 | 8,914 | 3,425,003 | 3,854,240 | $(429,237)$ |

## Operating Highlights

| (In thousands, except per share information) | Second Quarter |  |  | Six months ended June 30, |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | Variance | 2008 | 2007 | Variance |
| Net interest income | \$337,885 | \$371,417 | (\$ 33,532) | \$695,074 | \$726,399 | (\$ 31,325) |
| Provision for loan losses | 190,640 | 115,167 | 75,473 | 358,862 | 211,513 | 147,349 |
| Non-interest income | 193,572 | 203,375 | $(9,803)$ | 501,547 | 455,551 | 45,996 |
| Operating expenses | 347,733 | 361,053 | $(13,320)$ | 720,248 | 736,381 | $(16,133)$ |
| Income tax (benefit) expense | $(31,166)$ | 23,622 | $(54,788)$ | $(10,029)$ | 40,459 | $(50,488)$ |
| Net income | \$ 24,250 | \$ 74,950 | (\$50,700) | \$ 127,540 | \$ 193,597 | (\$ 66,057) |
| Net income applicable to common stock | \$ 18,247 | \$ 71,972 | (\$53,725) | \$ 118,559 | \$ 187,641 | (\$ 69,082) |
| Basic and diluted EPS | \$ 0.06 | \$ 0.26 | (\$ 0.20) | \$ 0.42 | \$ 0.67 | (\$ 0.25) |

## Selected Statistical Information

|  | Six months ended June <br> 30, |  |  |  |
| :--- | :---: | ---: | ---: | ---: |
|  | Second Quarter | 2007 |  |  |
| Common Stock Data | 2008 | 2007 | 2008 |  |
| High |  |  |  |  |
| Low |  |  | $\$ 14.07$ | $\$ 18.94$ |
| End | 13.06 | $\$ 17.49$ | 6.59 | 15.82 |
| Book value per share at period end | 6.59 | 15.82 | 6.59 | 16.07 |
| Dividends declared per share | 6.59 | 16.07 | 11.10 | 12.57 |
| Dividend payout ratio | 11.10 | 12.57 | 0.32 | $47.57 \%$ |
|  | 0.16 | 0.16 | $80.22 \%$ |  |
| Profitability Ratios $\quad$ Return on assets | $273.89 \%$ | $62.04 \%$ |  | $0.83 \%$ |
| Return on common equity |  |  | $0.61 \%$ | 10.32 |
| Net interest spread (taxable equivalent) | $0.24 \%$ | $0.64 \%$ | 7.11 | 2.99 |
| Net interest margin (taxable equivalent) | 2.08 | 7.80 | 3.47 | 3.52 |


| Effective tax rate | N.M. | 23.96 | N.M. | 17.29 |
| :--- | :---: | :---: | :---: | :---: |
|  |  |  |  |  |
| Capitalization Ratios | Equity to assets | $8.61 \%$ | $8.24 \%$ | $8.20 \%$ |
| Tangible equity to assets | 7.03 | 6.72 | 6.64 | 6.63 |
| Equity to loans | 12.67 | 11.86 | 12.10 | 11.78 |
| Internal capital generation | $3.25)$ | 2.81 | 1.28 | 5.10 |
| Tier I capital to risk | adjusted assets | 10.50 | 10.66 | 10.50 |
| Total capital to risk | adjusted assets | 11.77 | 11.92 | 11.77 |
| Leverage ratio | 8.52 | 8.17 | 8.52 | 11.96 |
|  |  |  |  | 8.17 |

N.M., not a meaningful value.

The Corporation, like other financial institutions, is subject to a number of risks, many of which are outside of management $s$ control, though efforts are made to manage those risks while optimizing returns. Among the risks to which the Corporation is subject are: (1) market risk, which is the risk that changes in market rates and prices will adversely affect the Corporation s financial condition or results of operations, (2) liquidity risk, which is the risk that the Corporation will have insufficient cash or access to cash to meet operating needs and financial obligations, (3) credit risk, which is the risk that loan customers or other counterparties will be unable to perform their contractual obligations, and (4) operational risk, which is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. In addition, the Corporation is subject to legal, compliance and reputational risks, among others.

## Table of Contents

As a financial services company, the Corporation s earnings are significantly affected by general business and economic conditions. Lending and deposit activities and fee income generation are influenced by the level of business spending and investment, consumer income, spending and savings, capital market activities, competition, customer preferences, interest rate conditions and prevailing market rates on competing products. The Corporation continuously monitors general business and economic conditions, industry-related indicators and trends, competition, interest rate volatility, credit quality indicators, loan and deposit demand, operational and systems efficiencies, revenue enhancements and changes in the regulation of financial services companies. The Corporation operates in a highly regulated environment and may be adversely affected by changes in federal and local laws and regulations. Also, competition with other financial institutions could adversely affect its profitability.
The description of the Corporation s business contained in Item 1 of the Corporation s Form 10-K for the year ended December 31, 2007, while not all inclusive, discusses additional information about the business of the Corporation and risk factors, many beyond the Corporation s control that, in addition to the other information in this Form 10-Q, readers should consider.
Further discussion of operating results, financial condition and credit, market and liquidity risks is presented in the narrative and tables included herein.
The shares of the Corporation s common (BPOP) and preferred stock (BPOPO and BPOPP) are traded on the National Association of Securities Dealers Automated Quotation ( NASDAQ ) system.

## RESTRUCTURING PLANS

## PFH Branch Network Restructuring Plan

Given the disruption in the capital markets since the summer of 2007 and its impact on funding, management of the Corporation concluded during the fourth quarter of 2007 that it would be difficult to generate an adequate return on the capital invested at Equity One s consumer service branches.
The Corporation closed Equity One s consumer service branches during the first quarter of 2008 as part of the initiatives to exit its subprime loan origination operations at PFH (the PFH Branch Network Restructuring Plan ). PFH continues to hold a $\$ 1.2$ billion maturing portfolio as of June 30, 2008. The PFH Branch Network Restructuring Plan followed the sale on March 1, 2008 of approximately $\$ 1.4$ billion of PFH consumer and mortgage loans that were originated through Equity One s consumer branch network to American General. This company hired certain of Equity One s consumer services employees and retained certain branch locations. During the quarter ended March 31, 2008, Equity One closed substantially all branches not assumed by American General. Full-time equivalent employees at the PFH reportable segment were 321 as of June 30, 2008, compared with 932 as of June 30, 2007. PFH continues to operate a mortgage loan servicing unit, a small scale origination / refinancing unit and to carry a maturing loan portfolio.
During the quarter and six months ended June 30, 2008 and as part of this particular restructuring plan, the Corporation incurred (reduced) certain costs, on a pre-tax basis, as detailed in the table below.

|  | Quarter <br> ended <br> June 30, | Six months <br> ended |
| :--- | :---: | :---: |
| (In thousands) | 2008 | June 30, 2008 |
| Personnel costs | $\$ 412$ | $\$ 8,405(\mathrm{a})$ |
| Net occupancy expenses | $(845)$ | $5,905(\mathrm{~b})$ |
| Equipment expenses |  | 675 |
| Communications |  | 590 |
| Other operating expenses | $(\$ 433)$ | $\$ 1,021(\mathrm{c})$ |
| Total restructuring charges |  | 16,596 |

(a)

Severance, retention bonuses and other benefits
(b) Lease terminations
(c) Contract cancellations and branch closing costs

## Table of Contents

Also, during the fourth quarter of 2007 and as disclosed in the 2007 Annual Report, the Corporation recognized impairment charges on long-lived assets of $\$ 1.9$ million, mainly associated with leasehold improvements, furniture and equipment.
As of June 30, 2008, the PFH Branch Network Restructuring Plan has resulted in combined charges for 2007 and 2008, broken down as follows:

|  | Impairments <br> on <br> long-lived <br> assets | costs | Testructuring |
| :--- | :---: | :---: | ---: |

The following table presents the changes during 2008 in the reserve for restructuring costs associated with the PFH Branch Network Restructuring Plan.
(In thousands)
Balance at January 1, 2008
Charges in quarter ended March 31
Cash payments
Balance at March 31,2008
Charges in quarter ended June 30
Cash payments
Reversals
Balance as of June 30,2008
The amounts accrued as of June 30,2008 related to the PFH Branch Network Restructuring Plan are expected to be
substantially paid during 2008 .
As disclosed in Note 24 to the consolidated financial statements, PFH s reportable segment reported net loss of
$\$ 31.8$ million for the six months ended June 30,2008, compared with a net loss of $\$ 80.5$ million for the same period
in the previous year. The following table summarizes the main categories in the statement of operations for PFH s

Six months ended

|  | June 30, | June 30, |  | Variance |
| :--- | :---: | :---: | :---: | :---: | Notes

Mortgage servicing fees, net of fair value adjustments
Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159
Gain (loss) on sale of loans and valuation adjustments on loans held-for-sale
Other operating income
Personnel costs
Restructuring plan costs and related charges
Other operating expenses
Income tax
Net loss

| $(621)$ | 3,652 | $(4,273)$ | (c) |
| ---: | :---: | :---: | :---: |
|  |  |  |  |
| $(38,942)$ |  | $(38,942)$ |  |
|  |  | 48,289 | $(\mathrm{~d})$ |
| 46,768 | $(1,521)$ | 3,755 |  |
| 6,005 | 2,250 | $(4,383)$ | (e) |
| 25,778 | 30,161 | 1,680 |  |
| 16,596 | 14,916 | $(13,281)$ | (f) |
| 24,240 | 37,521 | 28,027 |  |
| $(14,681)$ | $(42,708)$ |  |  |
|  |  |  |  |

(a) The decline was mostly due to a reduction in the loan portfolio as a result of exiting origination channels.

## Table of Contents

(b) The reduction in the provision for loan losses was also associated to decline in portfolio due to exiting origination channels, sale of loan portfolio to American General and reclassification of loans to fair value measurement
(SFAS No. 159). Allowance for loan losses to loans
held-in-portfolio was $2.57 \%$ as of June 30, 2008, compared with $1.85 \%$ as of June 30, 2007. PFH loans held-in-portfolio amounted to \$307 million as of June 30, 2008, compared with $\$ 7.3$ billion as of the same date in 2007.
(c) Refer to Note 7 to the consolidated financial statements for information on PFH s MSRs.
(d) 2008 results were mostly impacted by the gain on the sale of loans to

American
General in first
quarter of 2008,
partially offset
by fair value
adjustment on
loans
repurchased under payment indemnification clauses; 2007
results were mainly impacted by realized gains of $\$ 13.5$ million
related to the off-balance sheet securitization completed during the second quarter of 2007.
(e) Headcount was
reduced to 321
FTEs as of
June 30, 2008
after the closing
of the Equity
One branches, compared to 932
FTEs as of
June 30, 2007.
(f) The reduction
was principally
in professional
fees, net
occupancy,
business
promotion and communication
expenses.

## E-LOAN Restructuring Plan

As indicated in the 2007 Annual Report, in November 2007, the Corporation began a restructuring plan for its Internet financial services subsidiary E-LOAN (the E-LOAN Restructuring Plan ). This plan included a substantial reduction of marketing and personnel costs at E-LOAN and changes in E-LOAN s business model. The changes include concentrating marketing investment toward the Internet and the origination of first mortgage loans that qualify for sale
to government sponsored entities ( GSEs ). Also, as a result of escalating credit costs in the current economic environment and lower liquidity in the secondary markets for mortgage related products, in the fourth quarter of 2007, the Corporation determined to hold back the origination by E-LOAN of home equity lines of credit, closed-end second lien mortgage loans and auto loans. The E-LOAN Restructuring Plan resulted in charges recorded in the fourth quarter of 2007 amounting to $\$ 231.9$ million, which included $\$ 211.8$ million in non-cash impairment losses related to its goodwill and trademark intangible assets.
The cost-control plan initiative and changes in loan origination strategies incorporated as part of the plan resulted in the elimination of over 400 positions between the fourth quarter of 2007 and first quarter of 2008. Full-time equivalent employees at E-LOAN were 312 as of June 30, 2008, compared with 805 as of June 30, 2007.
The following table presents the changes in restructuring costs reserves for 2008 associated with the E-LOAN Restructuring Plan.
(In thousands)
Balance at January 1, 2008
Payments
Reversals
Balance at March 31, 2008
Payments
Balance at June 30, 2008
The Corporation does not expect to incur additional significant restructuring costs related to this specific E-LOAN

## Table of Contents

As indicated in Note 2 to the consolidated financial statements, the Corporation elected to measure at fair value certain loans and borrowings outstanding at January 1, 2008 pursuant to the fair value option provided by SFAS No. 159. These financial instruments, all of which pertained to the operations of Popular Financial Holdings that are running off, were as follows:

Approximately $\$ 1.2$ billion of whole loans held-in-portfolio by PFH outstanding as of December 31, 2007. These whole loans consist principally of first lien residential mortgage loans and closed-end second lien loans that were originated through the exited origination channels of PFH (e.g. asset acquisition, broker and retail channels), and home equity lines of credit that had been originated by E-LOAN but sold to PFH as part of the Corporation s 2007 U.S. reorganization whereby E-LOAN became a subsidiary of BPNA. Also, to a lesser extent, the loan portfolio included mixed-use / multi-family loans (small commercial category) and manufactured housing loans.

Management believes that accounting for these loans at fair value provides a more relevant and transparent measurement of the realizable value of the assets and differentiates the PFH portfolio from the loan portfolios that the Corporation will continue to originate through channels other than PFH.

Approximately $\$ 287$ million of owned-in-trust loans and $\$ 287$ million of bond certificates associated with PFH securitization activities that were outstanding as of December 31, 2007. The owned-in-trust loans are pledged as collateral for the bond certificates as a financing vehicle through on-balance sheet securitization transactions. These loan securitizations conducted by the Corporation did not meet the sale criteria under SFAS No. 140; accordingly, the transactions are treated as on-balance sheet securitizations for accounting purposes. Due to the terms of the transactions, particularly the existence of an interest rate swap agreement and, to a lesser extent, clean up calls, the Corporation was unable to recharacterize these loan securitizations as sales for accounting purposes in 2007. The owned-in-trust loans include first lien residential mortgage loans, closed-end second lien loans, mixed-use / multi-family loans (small commercial category) and manufactured housing loans. The majority of the portfolio is comprised of first lien residential mortgage loans.

These owned-in-trust loans do not pose the same magnitude of risk to the Corporation as those loans owned outright because certain of the potential losses related to owned-in-trust loans are born by the bondholders and not the Corporation. Upon the adoption of SFAS No. 159, the loans and related bonds are both measured at fair value, thus their net position better portrays the credit risk born by the Corporation.
Excluding the PFH loans elected for the fair value option as described above, PFH s reportable segment held approximately $\$ 1.8$ billion of additional loans at the time of fair value option election on January 1, 2008. Of these remaining loans, $\$ 1.4$ billion were classified as loans held-for-sale and were not subject to the fair value option as the loans were intended to be sold to an institutional buyer during the first quarter of 2008. These loans were sold in March 2008. The remaining $\$ 0.4$ billion in other loans held-in-portfolio at PFH as of that same date consisted principally of a small portfolio of auto loans that was acquired from E-LOAN, warehousing revolving lines of credit with monthly advances and pay-downs, and construction credit agreements in which permanent financing will be with a lender other than PFH. Although these businesses are running off, PFH must contractually continue to fund the revolving credit arrangements.
There were no other assets or liabilities elected for the fair value option after January 1, 2008.

## Table of Contents

Upon adoption of SFAS No. 159, the Corporation recognized a negative after-tax adjustment to beginning retained earnings due to the transitional adjustment for electing the fair value option, as detailed in the following table.

|  | Cumulative <br> effect |  |  |
| :--- | :---: | :---: | :---: |
| (In thousands) | December 31, <br> 2007 (Carrying | adjustment to <br> January 1, 2008 <br> retained <br> earnings <br> Gailue prior to | January 1, <br> 2008 <br> fair value <br> (Carrying <br> value |
| Loans | $\$ 1,481,297$ | $(\$ 494,180)$ | $\$ 987,117$ |
| after adoption) |  |  |  |

Pre-tax cumulative effect of adopting fair value option accounting
(\$408,555)
Net increase in deferred tax asset
146,724
After-tax cumulative effect of adopting fair value option accounting

As of January 1, 2008, the Corporation eliminated $\$ 37$ million in allowance for loan losses associated to the loan portfolio elected under the fair value option accounting and recognized it as part of the cumulative effect adjustment. As the loans are measured at fair value, there is no requirement to establish an allowance for loan losses with respect to these loan portfolios, as the fair value takes into consideration cumulative expected credit losses on the loan portfolio.
The significant fair value adjustments in the loan portfolios recorded upon adoption of SFAS No. 159 on January 1, 2008 were mainly the result of factors such as:

In general, the loan portfolio is, in the most part, considered subprime and due to market conditions, considered distressed assets in a very illiquid market.

The majority of first lien mortgage loans were originated in 2006 and 2007. Industry and internally derived credit metrics show a high loss severity in these vintages. Approximately $81 \%$ of this portfolio was considered subprime as of December 31, 2007.

The subprime component of second lien closed-end mortgage loans (classified as part of consumer loans) increased. There has been a significant deterioration in the delinquency profile of the portfolio, and migration to the 90+ day delinquent buckets impacting the potential loss exposure for the closed-end second lien loan portfolio leading to consideration of a $100 \%$ loss severity. Market data considered for the valuation showed property values obtained on subprime loans in foreclosure declining dramatically. As property values do not justify initiating a foreclosure action, the loan in essence behaves as an unsecured loan. A substantial share of PFH s closed-end second lien portfolio has combined loan-to-values greater than $90 \%$.

The consumer loans measured at fair value also include home equity lines of credit ( HELOCs ) that were transferred in 2007 from E-LOAN to PFH. Although this portfolio is considered prime based on FICO scores,
it has deteriorated. Similar to second lien closed-end loans, the HELOCs are also behaving as an unsecured loan. The loan-to-value characteristics of the portfolio also negatively impact its performance. These loans were mostly originated in 2006, when there was a peak in the real estate market. As the housing market continues to deteriorate, the Corporation noted continued deterioration in the combined loan-to-value profile of the portfolio that was also considered in the market valuation. The geographical distribution of this portfolio also negatively impacts its performance since a significant portion of the portfolio is concentrated in California. The Corporation no longer originates HELOCs in its E-LOAN or PFH operations as a result of the restructuring plan.

Other product types include small balance commercial and manufactured housing loans that are trading at distressed levels based on the small trading activity available for these products and the expected return by the investors rather than the actual performance and fundamentals of these loans.
With respect to the bond certificates, as these are collateralized with the cash flows received from the mortgage loans, their fair value is influenced by the decline in the fair value of the loans. Historical performance was analyzed layered with general macro economic and housing market expectations that led to the projected forward performance for each bond. Also, the valuation considered forward LIBOR curves and the market dictated rate of return for these types of investments. The Corporation s liquidity exposure with respect to the bond certificates is limited to the cash flows of

## Table of Contents

the loans placed as collateral on the securitization trust and any other related assets such as other real estate. Also, the Corporation advances funds under the terms of the loan servicing agreements.
The following table presents the differences as of June 30, 2008 between the aggregate fair value, including accrued interest, and aggregate unpaid principal balance ( UPB ) of those loans / notes payable for which the fair value option was elected.

|  | Aggregate fair <br> value as of <br> June | Aggregate UPB <br> as | Unrealized <br> (loss) gain |
| :--- | :---: | :---: | ---: |
| (In thousands) | 30,2008 |  |  | | of June 30, 2008 |
| :---: |

These financial instruments are segregated in the consolidated statement of condition in the following line items: Loans measured at fair value pursuant to SFAS No. 159 and Notes Payable measured at fair value pursuant to SFAS No. 159. As the loans are measured at fair value, there is no requirement to establish allowance for loan losses with respect to these loan portfolios.
During the quarter ended June 30, 2008, the Corporation recognized $\$ 35.9$ million in estimated net losses attributable to changes in the fair value of the loans and borrowings, which were included in the caption Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 in the consolidated statement of operations. The unfavorable fair value adjustments for the quarter consisted of $\$ 31.0$ million in net losses attributable to changes in the fair value of loans and $\$ 4.9$ million in net losses attributable to changes in the fair value of notes payable (bond certificates). The change in the fair value of the loans was principally due to increases in market interest rates as well as credit considerations.
Refer to Note 11 to the consolidated financial statements for further information on the impact of SFAS No. 159 and to the Critical Accounting Policies / Estimates section of this MD\&A for additional information on the valuation methodology and critical assumptions considered in the valuations of the financial instruments measured at fair value under the provisions of SFAS No. 159, which are categorized as Level 3 under the requirements of SFAS No. 157.

## RECENT ACCOUNTING PRONOUNCEMENTS AND INTERPRETATIONS

## SFAS No. 157 Fair Value Measurements

SFAS No. 157, issued in September 2006, defines fair value, establishes a framework of measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets carried at fair value will be classified and disclosed in one of the three categories in accordance with the hierarchy. The three levels of the fair value hierarchy are (1) quoted market prices for identical assets or liabilities in active markets, (2) observable market-based inputs or unobservable inputs that are corroborated by market data, and (3) unobservable inputs that are not corroborated by market data. SFAS No. 157 was effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the Financial Accounting Standards Board ( FASB ) issued financial staff position FSP FAS No. 157-2 which defers for one year the effective date for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value on a nonrecurring basis.

## Edgar Filing: POPULAR INC - Form 10-Q

The staff position also amends SFAS No. 157 to exclude SFAS No. 13 Accounting for Leases and its related interpretive accounting pronouncements that address leasing transactions. The Corporation adopted the provisions of SFAS No. 157 that were not deferred by FSP FAS No. 157-2, commencing in the first quarter of 2008. The provisions of SFAS No. 157 are to be applied prospectively. Refer to Note 12 to these consolidated financial statements for the disclosures required for the six-month period ended June 30, 2008. The adoption of SFAS No. 157 in January 1, 2008 did not have an impact in beginning retained earnings.

# Edgar Filing: POPULAR INC - Form 10-Q 

## Table of Contents

SFAS No. 159 The Fair Value Option for Financial Assets and Liabilities Including an Amendment of FASB Statement No. 115
In February 2007, the FASB issued SFAS No. 159, which provides companies with an option to report selected financial assets and liabilities at fair value. The election to measure a financial asset or liability at fair value can be made on an instrument-by-instrument basis and is irrevocable. The difference between the carrying amount and the fair value at the election date is recorded as a transition adjustment to beginning retained earnings. Subsequent changes in fair value are recognized in earnings. The statement also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet.
The Corporation adopted the provisions of SFAS No. 159 in January 2008 as previously described in the SFAS No. 159 Fair Value Option Election section in this MD\&A and in Note 11 to the consolidated financial statements. FSP FIN No. 39-1 Amendment of FASB Interpretation No. 39
In April 2007, the FASB issued Staff Position FSP FIN No. 39-1, which defines right of setoff and specifies what conditions must be met for a derivative contract to qualify for this right of setoff. It also addresses the applicability of a right of setoff to derivative instruments and clarifies the circumstances in which it is appropriate to offset amounts recognized for those instruments in the statement of condition. In addition, this FSP permits the offsetting of fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments. The adoption of FSP FIN No. 39-1 in January 2008 did not have a material impact on the Corporation s consolidated financial statements and disclosures. The Corporation s policy is not to offset the fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement nor to offset the fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments.
SFAS No. 141-R Statement of Financial Accounting Standards No. 141(R), Business Combinations (a revision of SFAS No. 141)
SFAS No. 141(R), issued in December 2007, will significantly change how entities apply the acquisition method to business combinations. The most significant changes affecting how the Corporation will account for business combinations under this statement include the following: the acquisition date will be the date the acquirer obtains control; all (and only) identifiable assets acquired, liabilities assumed, and noncontrolling interests in the acquiree will be stated at fair value on the acquisition date; assets or liabilities arising from noncontractual contingencies will be measured at their acquisition date at fair value only if it is more likely than not that they meet the definition of an asset or liability on the acquisition date; adjustments subsequently made to the provisional amounts recorded on the acquisition date will be made retroactively during a measurement period not to exceed one year; acquisition-related restructuring costs that do not meet the criteria in SFAS No. 146 Accounting for Costs Associated with Exit or Disposal Activities will be expensed as incurred; transaction costs will be expensed as incurred; reversals of deferred income tax valuation allowances and income tax contingencies will be recognized in earnings subsequent to the measurement period; and the allowance for loan losses of an acquiree will not be permitted to be recognized by the acquirer. Additionally, SFAS No. 141(R) will require new and modified disclosures surrounding subsequent changes to acquisition-related contingencies, contingent consideration, noncontrolling interests, acquisition-related transaction costs, fair values and cash flows not expected to be collected for acquired loans, and an enhanced goodwill rollforward. The Corporation will be required to prospectively apply SFAS No. 141(R) to all business combinations completed on or after January 1, 2009. Early adoption is not permitted. For business combinations in which the acquisition date was before the effective date, the provisions of SFAS No. 141(R) will apply to the subsequent accounting for deferred income tax valuation allowances and income tax contingencies and will require any changes in those amounts to be recorded in earnings. Management will be evaluating the effects that SFAS No. 141(R) will have on the financial condition, results of operations, liquidity, and the disclosures that will be presented on the consolidated financial statements.

SFAS No. 160 Statement of Financial Accounting Standards No. 160, Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51

## Table of Contents

In December 2007, the FASB issued SFAS No. 160, which amends ARB No. 51, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 will require entities to classify noncontrolling interests as a component of stockholders equity on the consolidated financial statements and will require subsequent changes in ownership interests in a subsidiary to be accounted for as an equity transaction. Additionally, SFAS No. 160 will require entities to recognize a gain or loss upon the loss of control of a subsidiary and to remeasure any ownership interest retained at fair value on that date. This statement also requires expanded disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective on a prospective basis for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, except for the presentation and disclosure requirements, which are required to be applied retrospectively. Early adoption is not permitted. Management will be evaluating the effects, if any, that the adoption of this statement will have on its consolidated financial statements.

## SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, an amendment of SFAS No. 133. The standard requires enhanced disclosures about derivative instruments and hedged items that are accounted for under SFAS No. 133 and related interpretations. The standard will be effective for all of the Corporation sinterim and annual financial statements for periods beginning after November 15, 2008, with early adoption permitted. The standard expands the disclosure requirements for derivatives and hedged items and has no impact on how the Corporation accounts for these instruments. Management will be evaluating the enhanced disclosure requirements.

## SFAS No. 162 The Hierarchy of Generally Accepted Accounting Principles

SFAS No. 162, issued by the FASB in May 2008, identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. This statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. Management does not expect SFAS No. 162 to have a material impact on the Corporation s consolidated financial statements. The Board does not expect that this statement will result in a change in current accounting practice. However, transition provisions have been provided in the unusual circumstance that the application of the provisions of this statement results in a change in accounting practice.
Staff Accounting Bulletin No. 109 (SAB 109 ) Written Loan Commitments Recorded at Fair Value through Earnings
On November 5, 2007, the SEC issued Staff SAB 109, which requires that the fair value of a written loan commitment that is marked-to-market through earnings should include the future cash flows related to the loan s servicing rights. However, the fair value measurement of a written loan commitment still must exclude the expected net cash flows related to internally developed intangible assets (such as customer relationship intangible assets). SAB 109 applies to two types of loan commitments: (1) written mortgage loan commitments for loans that will be held-for-sale when funded that are marked-to-market as derivatives under SFAS No. 133 (derivative loan commitments); and (2) other written loan commitments that are accounted for at fair value through earnings under SFAS No. 159 s fair-value election.
SAB 109 supersedes SAB 105, which applied only to derivative loan commitments and allowed the expected future cash flows related to the associated servicing of the loan to be recognized only after the servicing asset had been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained. SAB 109 will be applied prospectively to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The implementation of SAB 109 did not have a material impact to the Corporation s consolidated financial statements, including disclosures, for the six months ended June 30, 2008.

## Table of Contents

## FASB Staff Position (FSP) FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions

The objective of FSP FAS 140-3, issued by the FASB in February 2008, is to provide implementation guidance on whether the security transfer and contemporaneous repurchase financing involving the transferred financial asset must be evaluated as one linked transaction or two separate de-linked transactions.
Current practice records the transfer as a sale and the repurchase agreement as a financing. The FSP FAS 140-3 requires the recognition of the transfer and the repurchase agreement as one linked transaction, unless all of the following criteria are met: (1) the initial transfer and the repurchase financing are not contractually contingent on one another; (2) the initial transferor has full recourse upon default, and the repurchase agreement sprice is fixed and not at fair value; (3) the financial asset is readily obtainable in the marketplace and the transfer and repurchase financing are executed at market rates; and (4) the maturity of the repurchase financing is before the maturity of the financial asset. The scope of this FSP is limited to transfers and subsequent repurchase financings that are entered into contemporaneously or in contemplation of one another.
FSP FAS 140-3 will be effective for the Corporation on January 1, 2009. Early adoption is prohibited. The Corporation will be evaluating the potential impact of adopting this FSP.
FASB Staff Position (FSP) FAS 142-3, Determination of the Useful Life of Intangible Assets
FSP FAS 142-3, issued by the FASB in April 2008, amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142 Goodwill and Other Intangible Assets . In developing these assumptions, an entity should consider its own historical experience in renewing or extending similar arrangements adjusted for entity specific factors or, in the absence of that experience, the assumptions that market participants would use about renewals or extensions adjusted for the entity specific factors.
FSP FAS 142-3 shall be applied prospectively to intangible assets acquired after the effective date. This FSP will be effective for the Corporation on January 1, 2009. Early adoption is prohibited. The Corporation will be evaluating the potential impact of adopting this FSP.

## CRITICAL ACCOUNTING POLICIES / ESTIMATES

The accounting and reporting policies followed by the Corporation and its subsidiaries conform to generally accepted accounting principles in the United States of America and general practices within the financial services industry. Various elements of the Corporation s accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. These estimates are made under facts and circumstances at a point in time and changes in those facts and circumstances could produce actual results that differ from those estimates.
Management has discussed the development and selection of the critical accounting policies and estimates with the Corporation s Audit Committee. The Corporation has identified as critical accounting policies those related to securities classification and related values, loans and allowance for loan losses, retained interests on transfers of financial assets (valuations of residual interests and mortgage servicing rights), income taxes, goodwill and other intangible assets, and pension and postretirement benefit obligations. For a summary of the Corporation s previously identified critical accounting policies and estimates, refer to that particular section in the MD\&A included in Popular, Inc. s 2007 Financial Review and Supplementary Information to Stockholders, incorporated by reference in Popular, Inc. s Annual Report on Form 10-K for the year ended December 31, 2007 (the 2007 Annual Report ). Also, refer to Note 1 to the consolidated financial statements included in the 2007 Annual Report for a summary of the Corporation s significant accounting policies.
Furthermore, commencing in the first quarter of 2008, management identified as critical accounting policies and estimates the Fair Value Measurement of Financial Instruments as a result of the adoption of SFAS No. 157 and SFAS No. 159.

## Table of Contents

## Fair Value Measurement of Financial Instruments

Effective January 1, 2008, the Corporation is required to determine the fair market values of its financial instruments based on the fair value hierarchy established in SFAS No. 157, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.
The Corporation currently measures at fair value on a recurring basis its trading assets, available-for-sale securities, mortgage servicing rights and residual interests on a recurring basis. From time to time, the Corporation may be required to record at fair value other assets on a nonrecurring basis, such as loans held-for-sale, loans held-for-investment and certain other assets. These nonrecurring fair value adjustments typically result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. Also, the Corporation carries certain loans and borrowings at fair value in accordance with SFAS No. 159 as previously described in this MD\&A. The Corporation categorizes its assets and liabilities measured at fair value under the three-level hierarchy as required by SFAS No. 157. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used for fair value measurement are observable or unobservable. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from independent sources. Unobservable inputs reflect the Corporation s estimates about assumptions that market participants would use in pricing the asset or liability based on the best information available. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1-Unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date. Valuation on these instruments does not necessitate a significant degree of judgment since valuations are based on quoted prices that are readily available in an active market.

Level 2- Quoted prices other than those included in Level 1 that are observable either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or that can be corroborated by observable market data for substantially the full term of the financial instrument.

Level 3- Valuations include unobservable inputs that are supported by little or no market activity and that are significant to the fair value measurement of the financial asset or liability. The fair value is estimated using modeling techniques such as discounted cash flow analyses. These modeling techniques incorporate assessments regarding assumptions that market participants would use in pricing the asset or the liability, including assumptions about the risks inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of nonperformance. Assessments with respect to assumptions that market participants would make are inherently difficult to determine and use of different assumptions could result in material changes to these fair value measurements.
Refer to Note 12 to the consolidated financial statements for information on the Corporation s fair value measurement disclosures required by SFAS No. 157, including assets and liabilities categorized by the three levels of the hierarchy. As of June 30, 2008, approximately $\$ 7.9$ billion or $85 \%$ out of the $\$ 9.3$ billion of assets measured at fair value on a recurring basis used market-based or market-derived valuation inputs in their valuation methodology and, therefore, were classified as Level 1 or Level 2. Approximately $15 \%$ of the assets measured at fair value on a recurring basis were classified as Level 3 since their valuation methodology considered significant unobservable inputs. The bond certificates measured at fair value were classified as Level 3 in the hierarchy. Additionally, the Corporation reported $\$ 431$ million of financial assets that were measured at fair value on a nonrecurring basis during the six-month period ended June 30, 2008 that were still held as of such date and were all classified as Level 3 in the hierarchy. The estimate of fair value reflects the Corporation s judgment regarding appropriate valuation methods and assumptions. The amount of judgment involved in estimating the fair value of a financial instrument is affected by a number of factors, such as type of instrument, the liquidity of the market for the instrument, and the contractual characteristics of the instrument.
In determining fair value, the Corporation maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available.

## Table of Contents

If listed prices or quotes are not available, the Corporation employs valuation models that primarily use market-based inputs including yield curves, interest rates, volatilities, and credit curves, among other considerations. When market observable data is not available, the valuation of financial instruments becomes more subjective and involves substantial judgment. The need to use unobservable inputs generally results from the lack of market liquidity for certain types of loans and securities, which results in diminished observability of both actual trades and assumptions that would otherwise be available to value these instruments. When fair values are estimated based on modeling techniques, such as discounted cash flow models, the Corporation considers assumptions such as interest rates, prepayment speeds, default rates, loss severity rates and discount rates. Valuation adjustments are limited to those necessary to ensure that the financial instrument $s$ fair value is adequately representative of the price that would be received or paid in the marketplace. These adjustments include, for example, amounts that reflect counterparty credit quality, the Corporation s creditworthiness, and constraints on liquidity.
As of June 30, 2008, the Corporation s portfolio of trading and investment securities available-for-sale amounted to $\$ 8.2$ billion and represented $88 \%$ of the Corporation s assets measured at fair value on a recurring basis. As of June 30, 2008, net unrealized gains on the trading portfolio approximated $\$ 5$ million, while for securities available-for-sale the unrealized net losses approximated $\$ 22$ million. Fair values for most of the Corporation $s$ trading and investment securities are classified under the Level 2 category. Refer to Note 12 to the consolidated financial statements for more detailed information on the significant security types, hierarchy levels and general description of the particular valuation methodologies for trading and investment securities. Also, Note 5 provides a detail of the Corporation s investment securities available-for-sale, which represent a significant share of the financial assets measured at fair value as of June 30, 2008.
Residual interests from securitizations (included in trading and investment securities available-for-sale), which approximated $\$ 37$ million as of June 30,2008 , are valued using a discounted cash flow model that considers the underlying structure of the securitization and net estimated credit exposure, prepayment assumptions, discount rate and expected life. Refer to the Critical Accounting Policies / Estimates section of the 2007 Annual Report for information on the valuation methodology followed by the Corporation with respect to the residual interests, which are categorized as Level 3. Disclosure of the key economic assumptions used to measure the residual interests and a sensitivity analysis to adverse changes to these assumptions is included in Note 7 to the consolidated financial statements.
The fair value of a loan is impacted by the nature of the asset and the market liquidity and activity. When available, the Corporation uses observable market data, including recent closed market transactions, to value loans. When this data is unobservable, the Corporation uses valuation methodologies using current market interest rate data adjusted for factors such as credit risk. When appropriate, loans are valued using collateral values as a practical expedient. As previously indicated, the Corporation measured at fair value $\$ 845$ million in loans as of June 30, 2008 pursuant to the SFAS No. 159 election. These loans represented $9 \%$ of the Corporation s financial assets measured at fair value as of such date. The loans measured at fair value pursuant to SFAS No. 159 were valued internally and the assumptions were validated with sources such as market data, other price indicators and historical data. The current illiquidity in the market for certain loan products resulting from current distressed market conditions in the subprime sector poses a challenge in the observability of the price quotations. When estimating fair value, assumptions considered include prepayment speeds, default rates, loss severity rates and interest rate risk, among others. Mortgage servicing rights ( MSRs ), which amounted to $\$ 186$ million as of June 30, 2008, do not trade in an active market with readily observable prices. MSRs are priced using a discounted cash flow model. The valuation model considers servicing fees, portfolio characteristics, prepayments assumptions, delinquency rates, late charges, other ancillary revenues, cost to service and other economic factors. Refer to the Critical Accounting Policies / Estimates section of the 2007 Annual Report for information on the valuation

## Table of Contents

methodologies followed by the Corporation with respect to MSRs. Disclosure of the key economic assumptions used to measure MSRs and a sensitivity analysis to adverse changes to these assumptions is included in Note 7 to the consolidated financial statements.
The estimate of fair value of the bond certificates (derived from PFH securitizations) measured pursuant to the fair value option of SFAS No. 159 was determined utilizing a discounted cash flow model. The bond certificates had a fair value of $\$ 174$ million as of June 30, 2008. In determining the fair value, the historical performance of the bond certificates, as well as market historical performance, were taken into consideration. This past information layered with general macro economic and housing market expectations led to a projected forward performance for each securitization. Structural cash flows were based on the established performance assumptions and forward LIBOR curves.

## NET INTEREST INCOME

Tables B and C present the different components of the Corporation s net interest income, on a taxable equivalent basis, for the quarter and six months ended June 30, 2008, compared with the same periods in 2007, segregated by major categories of interest earning assets and interest bearing liabilities.
The interest earning assets include investment securities and loans that are exempt from income tax, principally in Puerto Rico ( P.R. ). The main sources of tax-exempt interest income are investments in obligations of the U.S. Government, some U.S. Government agencies and sponsored entities of the P.R. Commonwealth and its agencies, and assets held by the Corporation s international banking entities, which are tax-exempt under P.R. laws. To facilitate the comparison of all interest data related to these assets, the interest income has been converted to a taxable equivalent basis, using the applicable statutory income tax rates at each respective quarter and six-month period. The taxable equivalent computation considers the interest expense disallowance required by the P.R. tax law.
Average outstanding securities balances are based upon amortized cost excluding any unrealized gains or losses on securities available-for-sale. Average loan balances include the impact of the valuation adjustments on the loans and bonds as part of the adoption of SFAS No. 159. Refer to the SFAS No. 159 Fair Value Option Election of this MD\&A for further details. Non-accrual loans have been included in the respective average loan categories. Loan fees collected and costs incurred in the origination of loans are deferred and amortized over the term of the loan as an adjustment to interest yield. Interest income for the quarter and six months ended June 30, 2008 included a favorable impact of $\$ 5.2$ million and $\$ 12.1$ million, respectively, compared to an unfavorable impact for the quarter and six months ended June 30, 2007 of $\$ 2.5$ million and $\$ 5.4$ million, respectively. These balances consist principally of amortization of net loan origination costs (net of origination fees) and amortization of net premiums on loans purchased, partially offset by prepayment penalties and late payment charges. The positive variance in this category was mainly influenced by the fact that in 2008 the Corporation amortized less loan premiums since a substantial portion of the loan portfolio that was acquired at a premium in earlier years was part of the recharacterization transaction completed in December 2007 in which the Corporation achieved sale accounting and was able to remove the loans from its statement of condition.

## Table of Contents

TABLE B
Analysis of Levels \& Yields on a Taxable Equivalent Basis
Quarter ended June 30,


Edgar Filing: POPULAR INC - Form 10-Q


Note: The changes that are not due solely to volume or rate are allocated to volume and rate based on the proportion of the change in each category.

* Includes
commercial
construction
loans.
** Includes interest
bearing demand
deposits
corresponding
to certain government entities in Puerto Rico.

As shown in Table B, net interest income on a taxable equivalent basis for the second quarter of 2008 decreased substantially when compared with the same quarter of the previous year. This decrease was mainly driven by several initiatives undertaken by management to lower the amount of low yielding assets in the statement of condition as well as to reduce the exposure of the Corporation to the mortgage market and address liquidity needs. The decrease in the average balance of earning assets resulted in part from the following:

The recharacterization of approximately $\$ 3.2$ billion in subprime mortgage loans from PFH during
December 2007. This transaction allowed the Corporation to remove these loans from its financial statements.

## Table of Contents

The sale of approximately $\$ 1.4$ billion in mortgage and consumer loans from the PFH Branch Network during the first quarter of 2008 .

The Corporation s strategy of not reinvesting maturities of low yielding investments during 2007.
The sale of approximately $\$ 271$ million in auto loans from PFH during the fourth quarter of 2007.
The sale of approximately $\$ 101$ million in auto loans from E-LOAN during the second quarter of 2008.
The securitization into agency mortgage-backed securities ( MBS ) of approximately $\$ 232$ million in principal balance of residential mortgage loans originated in Puerto Rico from BPPR s loan portfolio and their sale in the secondary markets during the second quarter of 2008.

Lower origination activity in E-LOAN as a result of the restructuring plan, and the runoff of operations at PFH. These reductions were partially offset by a higher volume of commercial, construction, credit cards and personal loans. The increase in average interest bearing deposits was principally in brokered certificates of deposit. Refer to Balance Sheets comments for a general description of the main factor that drove the increase in brokered certificates of deposit during the third quarter of 2007.
The increase in the net interest margin, on a taxable equivalent basis, was mainly the result of the following factors: The Federal Reserve ( FED ) lowered the federal funds target rate by 325 basis points from June 30, 2007 to June 30, 2008. The decrease in market rates was the main driver of the reductions in the average cost of short-term borrowings and interest bearing deposits.

In addition to the reduction of the cost of funds, the net interest margin was also favorably impacted by the PFH loan recharacterization transaction. The mortgage loans subject to this treatment were mainly acquired through PFH s exited asset acquisition unit. As a result the yield had been negatively impacted by the amortization of the premium originally paid for the loans.

As part of the PFH loan recharacterization transaction that occurred during the 4th quarter of 2007, the Corporation recognized approximately $\$ 38$ million in residual interests at that time. These instruments were recorded as part of the trading portfolio and account for the majority of the increase in yield for the trading securities category.

The unfavorable valuation from the adoption of SFAS No. 159 resulted in a reduction of the average loan balance. As a result, the average yields for these loan portfolios, mainly mortgage and consumer, were favorably impacted.
Unfavorable items impacting net interest margin are detailed as follows:
Lower yields in commercial and construction loans, mainly in the floating rate portfolios which were negatively impacted by the decrease in market rates. As of June 30, 2008, approximately $64 \%$ of the commercial and construction loan portfolio had floating or adjustable interest rates.

Lower yields in the consumer loans. The decrease in yield for this particular category can be divided between the floating rate portfolios, such as home equity lines of credits, which were negatively impacted as a result of the decreases in market rates, and the origination of closed-end second mortgages in the U.S. mainland, which carry a lower rate than consumer loans originated in the Puerto Rico market.

The increase in the volume of brokered certificates of deposit during the second half of 2007 limited the expected benefit of reduced market rates in the overall cost of funds. The brokered certificates of deposit carried a higher rate than short-term borrowings for the second quarter of 2008.

Similar factors described in the paragraphs above influenced the net interest income variances for the six-month period ended June 30, 2008, as compared to the results for the same period in the previous year. Refer to Table C for the corresponding analysis of levels and yields.

Edgar Filing: POPULAR INC - Form 10-Q

## Table of Contents

TABLE C
Analysis of Levels \& Yields on a Taxable Equivalent Basis
Six-month period ended June 30,

\begin{tabular}{|c|c|c|c|c|c|c|c|c|c|c|c|}
\hline \multicolumn{3}{|c|}{Average Volume} \& \multicolumn{3}{|l|}{Average Yields / Costs} \& \& \multirow[b]{2}{*}{2008} \& \multirow[b]{2}{*}{Interest 2007} \& \multirow[b]{2}{*}{Variance (In thousands)} \& \multicolumn{2}{|l|}{Variance Attributable to} \\
\hline 208 \& \[
\begin{gathered}
2007 \\
\text { \$ in million }
\end{gathered}
\] \& \begin{tabular}{l}
Variance \\
s)
\end{tabular} \& 2008 \& 2007 \& Variance \& \& \& \& \& Rate \& Volum \\
\hline \& \& \& \& \& \& Money market \& \& \& \& \& \\
\hline 677 \& \$ 405 \& \$ 272 \& 3.27\% \& 5.46\% \& (2.19\%) \& investments \& \$ 11,004 \& \$ 10,949 \& \$ 55 (\$ \& 5,430) \& \$ 5,4 \\
\hline 8,279 \& 10,158 \& \((1,879)\) \& 5.12 \& 5.15 \& (0.03) \& Investment securities \& 211,937 \& 261,259 \& \((49,322)\) \& (971) \& \\
\hline 815 \& 627 \& 188 \& 9.01 \& 6.36 \& 2.65 \& Trading securities \& 36,511 \& 19,777 \& 16,734 \& 9,778 \& 6,9 \\
\hline \multirow[t]{2}{*}{9,771} \& 11,190 \& \((1,419)\) \& 5.32 \& 5.22 \& 0.10 \& \& 259,452 \& 291,985 \& \((32,533)\) \& 3,377 \& (35,9 \\
\hline \& 14,770 \& 965 \& 6.44 \& 7.81 \& \& \begin{tabular}{l}
Loans: \\
Commercial \\
*
\end{tabular} \& 504,112 \& 572,340 \& \& , \& , 8 \\
\hline 1,115 \& 1,196 \& (81) \& 8.05 \& 7.85 \& 0.20 \& Leasing \& 44,900 \& 46,948 \& \((2,048)\) \& 1,173 \& (3,2 \\
\hline 6,111 \& 11,412 \& \((5,301)\) \& 7.81 \& 7.13 \& 0.68 \& Mortgage \& 238,477 \& 406,670 \& \((168,193)\) \& 35,648 \& (203,8 \\
\hline 5,339 \& 5,334 \& 5 \& 10.56 \& 10.78 \& (0.22) \& Consumer \& 280,812 \& 285,759 \& \((4,947)\) \& \((13,898)\) \& 8,9 \\
\hline 8,300 \& 32,712 \& \((4,412)\) \& 7.58 \& 8.06 \& (0.48) \& \& 1,068,301 \& 1,311,717 \& \((243,416)\) \& \((80,128)\) \& (163,2 \\
\hline \multirow[t]{2}{*}{8,071} \& \$43,902 \& (\$

$5,831)$ \& 7.00\% \& 7.34\% \& (0.34\%) \& Total earning assets \& \$1,327,753 \& \$ 1,603,702 \& (\$ 275,949) (\$ \& 76,751) \& (\$ 199,1 <br>
\hline \& \& \& \& \& \& Interest bearing deposits: NOW and money \& \& \& \& \& <br>

\hline \& $$
\begin{aligned}
& 4,202 \\
& 5,770
\end{aligned}
$$ \& (139) \& \[

$$
\begin{aligned}
& 2.00 \% \\
& 1.62
\end{aligned}
$$

\] \& \[

$$
\begin{aligned}
& 2.57 \% \\
& 1.98
\end{aligned}
$$

\] \& \[

$$
\begin{aligned}
& (0.57 \% \\
& (0.36)
\end{aligned}
$$

\] \& Savings \& \[

$$
\begin{array}{ll}
\$ \quad 49,155 \\
& 45,234
\end{array}
$$

\] \& \[

$$
\begin{array}{ll}
\$ & 54,655 \\
56,576
\end{array}
$$

\] \& $(11,342)$ \& \[

$$
\begin{aligned}
& 13,859) \\
& (7,206)
\end{aligned}
$$

\] \& \[

$$
\begin{array}{r}
8,3 \\
(4,1
\end{array}
$$
\] <br>

\hline 2,554 \& 10,550 \& 2,004 \& 4.30 \& 4.68 \& (0.38) \& Time deposits \& 268,596 \& 244,601 \& 23,995 \& $(26,690)$ \& 50,68 <br>
\hline 3,123 \& 20,602 \& 2,521 \& 3.16 \& 3.48 \& (0.32) \& \& 362,985 \& 355,832 \& 7,153 \& $(47,755)$ \& 54,9 <br>
\hline 6,003 \& 9,522 \& $(3,519)$ \& 3.61 \& 5.17 \& (1.56) \& Short-term borrowings Medium and long-term \& 107,647 \& 244,275 \& $(136,628)$ \& $(63,471)$ \& (73, 1 <br>
\hline 4,215 \& 8,418 \& $(4,203)$ \& 5.50 \& 5.55 \& (0.05) \& \& 115,392 \& 232,000 \& $(116,608)$ \& $(10,293)$ \& (106, 3 <br>
\hline
\end{tabular}



Note: The changes that are not due solely to volume or rate are allocated to volume and rate based on the proportion of the change in each category.

* Includes
commercial
construction
loans.
** Includes interest
bearing demand
deposits
corresponding
to certain
government
entities in
Puerto Rico.

The provision for loan losses totaled $\$ 190.6$ million or $163 \%$ of net charge-offs for the quarter ended June 30, 2008, compared with $\$ 115.2$ million or $125 \%$, respectively, for the same quarter in 2007. The provision for loan losses for the quarter ended June 30, 2008, when compared with the same quarter in 2007, reflects higher net charge-offs by $\$ 24.5$ million. Also, the higher level of provision for the quarter ended June 30, 2008 reflects current economic conditions, including a recessionary cycle in Puerto Rico, and deteriorating credit quality trends, primarily in the Puerto Rico commercial and construction loan portfolio and in the U.S. consumer loan portfolio. Further information

## Table of Contents

on net charge-offs and non-performing assets is provided in the Credit Risk Management and Loan Quality section of this MD\&A.

## NON-INTEREST INCOME

Refer to Table D for a breakdown of non-interest income by major categories for the quarters and six months ended June 30, 2008 and 2007.
TABLE D
Non-Interest Income

| (In thousands) | Quarter ended June 30, |  |  | Six months ended June 30, |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | \$ Variance | 2008 | 2007 | \$ Variance |
| Service charges on deposit accounts | \$ 51,799 | \$ 48,392 | \$ 3,407 | \$ 102,886 | \$ 96,863 | \$ 6,023 |
| Other service fees: |  |  |  |  |  |  |
| Credit card fees and discounts | 27,282 | 24,999 | 2,283 | 54,526 | 48,523 | 6,003 |
| Debit card fees | 26,340 | 16,855 | 9,485 | 51,710 | 32,956 | 18,754 |
| Insurance fees | 13,507 | 14,720 | $(1,213)$ | 26,202 | 27,669 | $(1,467)$ |
| Processing fees | 13,158 | 11,677 | 1,481 | 25,543 | 23,789 | 1,754 |
| Sale and administration of investment products | 8,079 | 7,311 | 768 | 19,076 | 14,571 | 4,505 |
| Mortgage servicing fees, net of amortization and fair value |  |  |  |  |  |  |
| adjustments | 11,868 | 4,641 | 7,227 | 18,817 | 10,869 | 7,948 |
| Trust fees | 3,052 | 2,530 | 522 | 6,132 | 4,926 | 1,206 |
| Other fees | 6,793 | 6,857 | (64) | 13,540 | 14,136 | (596) |
| Total other service fees | 110,079 | 89,590 | 20,489 | 215,546 | 177,439 | 38,107 |
| Net gain on sale and valuation |  |  |  |  |  |  |
| Trading account profit (loss) | 16,711 | 10,377 | 6,334 | 21,175 | $(3,787)$ | 24,962 |
| Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 | $(35,922)$ |  | $(35,922)$ | $(38,942)$ |  | $(38,942)$ |
| (Loss) gain on sale of loans and valuation adjustments on loans |  |  |  |  |  |  |
| held-for-sale | $(1,453)$ | 28,294 | $(29,747)$ | 67,292 | 31,728 | 35,564 |
| Other operating income | 24,595 | 25,547 | (952) | 57,887 | 70,362 | $(12,475)$ |
| Total non-interest income | \$ 193,572 | \$203,375 | (\$ 9,803) | \$501,547 | \$455,551 | \$ 45,996 |

The variance in non-interest income for the quarter and six-month periods was mostly impacted by:
Other service fees for the quarter and six-month period ended June 30, 2008 increased when compared to the same periods of the previous year. A detail of other service fees by category is shown in Table D. Debit card fees rose principally due to higher revenues from merchants as a result of a change in the pricing structure for transactions processed from a fixed charge per transaction to a variable rate based on the amount of the transaction, as well as higher surcharging income from the use of Popular s automated teller machine network. Also, mortgage servicing fees increased as a result of higher servicing fees due to the growth in the portfolio of mortgage loans serviced for others, which rose by approximately $\$ 5.0$ billion from June 30, 2007 to June 30,

2008, and as a result of lower negative impact, on a consolidated basis, of changes in the fair value of the servicing rights.

Net gain on sale and valuation adjustments of investment securities consisted of the following:

| (In thousands) | Quarter ended June 30, |  |  | Six months ended June 30, |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | \$ |  |  | \$ |
|  | 2008 | 2007 | Variance | 2008 | 2007 | Variance |
| Net gain on sale of investment securities | \$ 28,332 | \$ 2,493 | \$ 25,839 | \$78,561 | \$ 121,219 | (\$42,658) |
| Valuation adjustments of investment securities | (569) | $(1,318)$ | 749 | $(2,858)$ | $(38,273)$ | 35,415 |
| Total | \$ 27,763 | \$ 1,175 | \$ 26,588 | \$75,703 | \$ 82,946 | (\$7,243) |

During the quarter ended June 30, 2008, the Corporation realized approximately $\$ 28.3$ million in capital gains from sales of $\$ 2.4$ billion in U.S. agency securities to reduce its vulnerability to declining interest rates. The proceeds were reinvested primarily in U.S. agency securities, and to a lesser extent in mortgage-backed

## Table of Contents

securities with a longer average duration.
The decrease in the net gain on sale of investment securities for the six-month period ended June 30, 2008, compared with the same period in 2007, was mostly related to $\$ 118.7$ million in realized gains on the sale of the Corporation s interest in Telecomunicaciones de Puerto Rico, Inc. ( TELPRI ) during the first quarter of 2007. This was partially offset by $\$ 49.3$ million in realized gains due to the redemption by Visa of shares of common stock held by the Corporation during the first quarter of 2008 and to the impact of the aforementioned sale of U.S. agency securities during the second quarter of 2008.
The unfavorable valuation adjustments of investment securities during the six-month period ended June 30, 2007 were principally related to PFH s residual interests classified as available-for-sale, which were negatively impacted by the unfavorable conditions in the subprime market. The balance in the residual interests classified as available-for-sale decreased from $\$ 18.7$ million as of June 30, 2007 to $\$ 2.6$ million as of June 30, 2008, the Corporation having written down their value for the most part in 2007.

Trading account profit (loss) broken down as follows:

| (In thousands) | Quarter ended June 30, |  |  | Six months ended June 30, |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | \$ |  |  | \$ |
|  | 2008 | 2007 | Variance | 2008 | 2007 | Variance |
| Mark-to-market of PFH s residual interests | (\$ 1,831) | (\$ 835) | (\$ 996) | $(\$ 10,704)$ | (\$24,313) | \$ 13,609 |
| Other trading account profit | 18,542 | 11,212 | 7,330 | 31,879 | 20,526 | 11,353 |
| Total | \$16,711 | \$ 10,377 | \$ 6,334 | \$ 21,175 | (\$ 3,787) | \$ 24,962 |

The increase in trading account profit for the quarter and six months ended June 30, 2008 was related to a gross gain of approximately $\$ 8.8$ million related to the sale of approximately $\$ 232$ million in principal balance of residential mortgage loans originated in Puerto Rico from BPPR s portfolio, which were securitized into Fannie Mae mortgage-backed securities and sold in the secondary markets.
The decrease in the write-downs of PFH s residual interests classified as trading securities during the six-month period ended June 30, 2008, when compared to the same period of the previous year, was due to the changes in the assumptions used to determine their fair value, which were more dramatic during 2007 when conditions in the subprime market were deteriorating considerably. Also, the decrease resulted because a substantial amount of PFH s residual interests were written down during 2007, and therefore, the average balance of residual interests was much lower during the first six months of 2008. Refer to Note 7 to the consolidated financial statements for information on key economic assumptions used in measuring the fair value of the residual interests as of June 30, 2008. Also, Note 7 contains a sensitivity analysis based on immediate changes to the most critical assumptions used in the valuations as of June 30, 2008. As of such date, there were $\$ 35$ million in residual interests held by PFH that were classified as trading securities.

Net losses attributable to changes in the fair value of PFH loans and bond certificates measured at fair value pursuant to SFAS No. 159, which was adopted in 2008, amounted to $\$ 35.9$ million for the quarter ended June 30, 2008 and $\$ 38.9$ million for the six months ended June 30, 2008. The $\$ 35.9$ million of net losses for the quarter includes losses of $\$ 31.0$ million related to the loans and losses of $\$ 4.9$ million associated with the bond certificates. The $\$ 38.9$ million of net losses for the six-month period includes losses of $\$ 32.7$ million associated with the loans and losses of $\$ 6.2$ million related to the bond certificates. Refer to the SFAS No. 159 Fair Value Option Election sections of this MD\&A for further information on these financial instruments.

## Table of Contents

Gain on sales of loans and unfavorable valuation adjustments on loans held-for-sale, which are broken down as follows:


The decrease in the above caption for the quarter ended June 30, 2008, compared to the same quarter of the previous year, was in part related to PFH completing one off-balance sheet mortgage loan securitization during 2007 involving $\$ 461$ million in loans with realized gains of approximately $\$ 13.5$ million. No securitizations were performed by PFH during 2008 as a result of PFH exiting the wholesale subprime mortgage business. Also, E-LOAN had lower gains on sales of mortgage loans by $\$ 14.7$ million, in the most part related to lower origination volumes and lower yields due to the weakness in the U.S. mainland mortgage and housing market and the downsizing of E-LOAN s operations, and to a lesser extent, due to $\$ 4.3$ million in losses as a result of a sale of approximately $\$ 101$ million in auto loans that were originated prior to the restructuring at that subsidiary. Also, during the quarter ended June 30, 2008, the Corporation recorded losses of approximately $\$ 7.1$ million related to $\$ 12.3$ million in loans classified as held-for-sale which were repurchased under payment default indemnification clauses that terminated in April 2008.
The increase in gains on sales of loans for the six months ended June 30, 2008, when compared to the same period of the previous year, was primarily related to the sale of loans by PFH to American General during 2008, which contributed with a gain of approximately $\$ 47.4$ million, net of fair value adjustments on loans repurchased under indemnification clauses, partially offset by the off-balance sheet securitization completed during 2007. Also, there were lower sales volume due to shutdown of the loan origination activities at PFH and to the restructuring plan at E-LOAN which commenced in the fourth quarter of 2007. The unfavorable valuation adjustments of mortgage loans held-for-sale during the quarter and six-month period ended June 30, 2007 resulted principally from deterioration in the U.S. subprime market.

Lower other operating income in the six months ended June 30, 2008, compared with the same period in 2007, resulted mainly from lower revenues derived from investments accounted under the equity method, lower other referral and escrow closing services income from E-LOAN due to the downsizing of its operations, and lower gains on the sale of real estate, among others. These unfavorable variances were partially offset by the gain of $\$ 12.8$ million recorded in the first quarter of 2008 related to the sale of BPNA s retail bank branches as previously described.

Table of Contents

## OPERATING EXPENSES

Refer to Table E for a breakdown of operating expenses by major categories.
TABLE E
Operating Expenses

|  | Quarter ended June 30, |  |  | Six months ended June 30, |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| (In thousands) | 2008 | 2007 | $\$$ Variance | 2008 | 2007 | $\$$ Variance |  |
|  |  |  |  |  |  |  |  |
| Personnel costs | $\$ 161,885$ | $\$ 164,288$ | $(\$ 2,403)$ | $\$ 337,064$ | $\$ 342,663$ | $(\$ 5,599)$ |  |
| Net occupancy expenses | 26,362 | 26,501 |  | $(139)$ | 61,354 | 58,515 | 2,839 |
| Equipment expenses | 30,724 | 32,245 |  | $(1,521)$ | 62,722 | 64,641 | $(1,919)$ |
| Other taxes | 13,879 | 11,835 |  | 2,044 | 27,022 | 23,682 | 3,340 |
| Professional fees | 31,627 | 38,642 | $(7,015)$ | 68,252 | 74,629 | $(6,377)$ |  |
| Communications | 13,145 | 16,973 | $(3,828)$ | 28,448 | 34,035 | $(5,587)$ |  |
| Business promotion | 18,251 | 30,369 | $(12,118)$ | 35,467 | 58,741 | $(23,274)$ |  |
| Printing and supplies | 3,899 | 4,549 | $(650)$ | 8,174 | 8,825 | $(651)$ |  |
| Other operating expenses | 45,471 | 32,838 | 12,633 | 86,763 | 64,854 | 21,909 |  |
| Amortization of |  |  |  |  |  |  |  |
| intangibles | 2,490 | 2,813 |  | $(323)$ | 4,982 | 5,796 | $(814)$ |
|  |  |  |  |  |  |  |  |
| Total | $\$ 347,733$ | $\$ 361,053$ | $(\$ 13,320)$ | $\$ 720,248$ | $\$ 736,381$ | $(\$ 16,133)$ |  |

Operating expenses for the second quarter of 2008 decreased by approximately $4 \%$, compared with the same quarter in 2007. For the six-month period ended June 30,2008 , operating expenses decreased by $2 \%$, compared with the same period of the previous year. The following restructuring costs were included in operating expenses:
Breakdown of Restructuring Costs
Quarter ended June 30,

| (In thousands) |  |  |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 |  |  | 2007 | Variance |  |  | 2008 | 2007 |  | Variance |  |
| Personnel costs |  | 412 | (\$ | 34) | \$ | 446 | \$ | 8,104 | \$ | 8,124 | (\$ | 20) |
| Net occupancy expenses |  | (845) |  |  |  | (845) |  | 5,905 |  | 4,413 |  | 1,492 |
| Equipment expenses |  |  |  |  |  |  |  | 675 |  | 281 |  | 394 |
| Professional fees |  |  |  | (185) |  | 185 |  |  |  | 1,762 |  | $(1,762)$ |
| Communications |  |  |  |  |  |  |  | 590 |  | 67 |  | 523 |
| Other operating expenses |  |  |  |  |  |  |  | 1,021 |  | 269 |  | 752 |
| Total |  | 433) | (\$ | 219) | (\$ | 214) |  | 6,295 |  | 4,916 | \$ | 1,379 |

Full-time equivalent employees ( FTEs ) were 11,233 as of June 30, 2008, a decrease of 925 from the same date in 2007. PFH and E-LOAN contributed with lower FTEs by 1,104 on a combined basis. The reduction in FTEs was partially offset by new hires in other of the Corporation s subsidiaries as well as the workforce that joined the Corporation from the acquisition of the Citibank retail branches in Puerto Rico. The impact of the reduction in headcount was offset in part by lower deferred salaries due to lower volume loan originations as a result of the shutdown and downsizing of certain of the Corporation s U.S. operations as described earlier, and the impact of annual salary revisions.
The reduction in business promotion for the quarter and six months ended June 30, 2008, when compared to the same period of the previous year, resulted principally from the downsizing of E-LOAN s operations.

Professional fees also decreased as a result of lower consulting fees and loan origination costs such as appraisals and title recording fees at PFH and E-LOAN, and to $\$ 1.8$ million in restructuring costs incurred during the six months ended June 30, 2007 for professional services related to the PFH Restructuring and Integration Plan. This was partially offset by increases in collection fees, appraisal charges, IT consulting development, ATM switch processing, and merchant processing fees in the Corporation s Puerto Rico operations. Equipment and communication expenses also decreased mostly as a result of the streamlining of the PFH and E-LOAN operations.
Partially offsetting these variances were higher other operating expenses for the quarter and six months ended June 30, 2008, when compared to the same periods of the previous year. Other operating expenses increased mainly as a

## Table of Contents

result of the $\$ 10.1$ million in reserves for unfunded loan commitments recorded during the second quarter of 2008, primarily related to commercial and consumer lines of credit. Also, there were higher FDIC insurance assessments in the U.S. banking subsidiary. Other operating expenses also increased for the six-month period as a result of higher credit card interchange and processing costs, higher FDIC insurance assessments, and losses on the sale of other real estate properties.

## INCOME TAXES

Income tax benefit amounted to $\$ 31.2$ million for the quarter ended June 30, 2008, compared with income tax expense of $\$ 23.6$ million for the same quarter of 2007. This variance was primarily due to the losses in the Corporation s U.S. operations for the second quarter of 2008. In addition, there was an increase in income subject to a lower preferential tax rate on capital gains applicable to Puerto Rico corporations for the second quarter of 2008 as compared to the same quarter of 2007. Beginning July 1, 2007, the capital gain tax rate for Puerto Rico corporations was reduced from $20 \%$ to $15 \%$. The components of the income tax benefit for the quarter ended June 30, 2008 is as follows:

|  | Puerto Rico and other jurisdictions |  | U.S. jurisdiction |  | Consolidated |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands) | Amount | $\%$ of pre-tax income | Amount | $\%$ of pre-tax loss | Amount | $\begin{gathered} \% \text { of } \\ \text { pre-tax } \\ \text { loss } \end{gathered}$ |
| Computed income tax at statutory rates | \$ 48,289 | 39\% | (\$45,757) | 35\% | \$ 2,532 | (37\%) |
| Benefits of net tax exempt interest income | $(13,871)$ | (11) | (877) | 1 | $(14,748)$ | 213 |
| Effect of income subject to preferential tax rate | $(8,651)$ | (7) |  |  | $(8,651)$ | 125 |
| Difference in tax rates due to multiple jurisdictions | $(1,467)$ | (1) |  |  | $(1,467)$ | 21 |
| State taxes and others | $(5,552)$ | (4) | $(3,280)$ | 3 | $(8,832)$ | 128 |
| Income tax expense (benefit) | \$ 18,748 | 15\% | $(\$ 49,914)$ | 38\% | (\$ 31,166) | 451\% |

Income tax benefit amounted to $\$ 10.0$ million for the six-month period ended June 30, 2008, compared with income tax expense of $\$ 40.5$ million for the same period in 2007. The reduction in income tax expense was primarily due to lower pre-tax earnings, and higher exempt interest income net of disallowance of expenses attributed to such exempt income.
The Corporation s net deferred tax assets as of June 30, 2008 amounted to $\$ 808$ million, compared with $\$ 525$ million as of December 31, 2007. The net deferred tax assets as of June 30, 2008 consisted principally of $\$ 264$ million related to timing differences in the recognition of the provision for loan losses under GAAP and actual net charge-offs under the tax code, $\$ 210$ million related to net operating losses carryforward in the U.S. operations, and $\$ 151$ million related to the measurement of certain loans and bond certificates of PFH at fair value (SFAS No. 159). The realization of the deferred tax asset is dependent upon the existence of, or generation of, sufficient taxable income to utilize the deferred tax asset. The only portion of the deferred tax asset that has a limited life is the portion related to the net operating loss carryforward of the Corporation s U.S. operations. Since its expiration term is of 20 years, the Corporation expects to generate enough taxable income prior to such expiration term to fully realize it. Refer to Item 1A. Risk Factors included in the Corporation s Form 10-K for the year ended December 31, 2007 for disclosures on risk factors associated with deferred tax assets.

## REPORTABLE SEGMENT RESULTS

The Corporation s reportable segments for managerial reporting purposes consist of Banco Popular de Puerto Rico, EVERTEC, Banco Popular North America and PFH. Also, a Corporate group has been defined to support the
reportable segments. For managerial reporting purposes, the costs incurred by this latter group are not allocated to the four reportable segments. For a description of the Corporation s reportable segments, including additional financial information and the underlying management accounting process, refer to Note 24 to the consolidated financial statements. Financial information for interim periods prior to 2008 was restated to conform to the 2008 presentation.

## Table of Contents

The Corporate group had a net loss of $\$ 8.5$ million in the second quarter of 2008, compared with a net loss of $\$ 13.0$ million in the same quarter of 2007. The Corporate group had net losses of $\$ 18.2$ million for the six months ended June 30, 2008, compared with net income of $\$ 75.5$ million for the same period in 2007. During the six months ended June 30, 2007, the Corporate group realized net gains on the sale and valuation adjustment of investment securities approximating $\$ 108.1$ million, mainly due to gains on the sale of the Corporation s interest in TELPRI during the second quarter of 2007 , representing the principal contributor to the variance in the financial results between 2007 and 2008 comparable six-month periods.
Highlights on the earnings results for the reportable segments are discussed below.

## Banco Popular de Puerto Rico

The Banco Popular de Puerto Rico reportable segment reported net income of $\$ 92.5$ million for the quarter ended June 30, 2008, an increase of $\$ 11.9$ million, or $15 \%$, when compared with the same quarter in the previous year. The main factors that contributed to the variance in results for the quarter ended June 30, 2008, when compared to the second quarter of 2007, included:
higher net interest income by $\$ 6.1$ million, or $3 \%$, primarily due to lower cost of funds in short-term debt and time deposits due to a lower rate environment in the latter part of 2007 and 2008 and higher average volume of earning assets, mainly in commercial, construction and consumer loans. These favorable variances were partially offset by lower interest income derived from investment securities due to lower average volume outstanding, higher interest expense due to greater volume of deposits, including brokered certificates of deposit, and the resetting of the floating rate loan portfolios in a lower interest rate scenario.
higher provision for loan losses by $\$ 44.3$ million, or $70 \%$, primarily associated with the current economic conditions, including a recessionary cycle in Puerto Rico and deteriorating quality trends in the commercial and construction loan portfolios. The ratio of allowance for loan losses to loans held-in-portfolio for the Banco Popular de Puerto Rico reportable segment was $2.86 \%$ as of June 30, 2008, compared with $2.17 \%$ as of June 30, 2007. The provision for loan losses represented $154 \%$ of net charge-offs for the second quarter of 2008, compared with $130 \%$ of net charge-offs in the same period of 2007. The net charge-offs to average loans held-in-portfolio for the Banco Popular de Puerto Rico operations was $0.43 \%$ for the quarter ended June 30, 2008, compared with $0.32 \%$ in the same quarter of the previous year.
higher non-interest income by $\$ 60.0$ million, or $48 \%$, mainly due to a favorable variance in the caption of other service fees during the second quarter of 2008, principally related to increase fee income from debit cards and credit cards and higher mortgage servicing fees. Also, there were higher gains on sale of securities by $\$ 22.7$ million, mainly as a result of the aforementioned gain on sale of $\$ 2.4$ billion in U.S. agency securities during the second quarter of 2008, and higher trading profits by $\$ 7.3$ million, principally due to the sale of mortgage-backed securities. As explained in Note 24 to the financial statements, management distributes a proportionate share of the investment function of BPPR between the commercial banking and the consumer and retail banking businesses of BPPR. In the additional disclosures of the Banco Popular de Puerto Rico reportable segment presented in Note 24, the capital gain specifically related to the sale of the U.S. agencies securities in the quarter ended June 30, 2008 was distributed $\$ 8.3$ million ( $\$ 7.0$ million after-tax) to the commercial banking business and $\$ 20.0$ million ( $\$ 17.0$ million after-tax) to the consumer and retail banking business of BPPR.
higher operating expenses by $\$ 18.2$ million, or $10 \%$, primarily associated with higher personnel costs, professional fees, net occupancy, other taxes and other operating expenses. Included in other operating expenses were $\$ 6.5$ million in reserves for unfunded loan commitments, primarily related to commercial and consumer lines of credit.
lower income taxes by $\$ 8.3$ million, or $30 \%$.

Net income for the six months ended June 30, 2008 totaled $\$ 191.3$ million, an increase of $\$ 24.4$ million, or $15 \%$, compared with the same period in the previous year. These results reflected:
higher net interest income by $\$ 18.5$ million, or $4 \%$;
higher provision for loan losses by $\$ 99.8$ million, or $90 \%$;
higher non-interest income by $\$ 120.9$ million, or $50 \%$;
higher operating expenses by $\$ 31.6$ million, or $8 \%$; and

## Table of Contents

lower income tax expense by $\$ 16.3$ million, or $28 \%$.
Factors similar to those described in the quarterly variances above were the contributors to the variances in the six-month periods. Also included in non-interest income for 2008 was the gain on redemption of Visa stock amounting to approximately $\$ 40.9$ million recognized in the first quarter of 2008.

## EVERTEC

EVERTEC s net income for the quarter ended June 30, 2008 totaled $\$ 13.5$ million, an increase of $\$ 6.9$ million, or $105 \%$, compared with the results of the same quarter in the previous year.
The principal factors that contributed to the variance in results for the quarter ended June 30, 2008, when compared with the second quarter of 2007, included:
higher non-interest income by $\$ 6.0$ million, or $10 \%$, primarily due to higher electronic transactions processing fees mainly related to the automated teller machine ( ATM ) network and point-of-sale ( POS ) terminals, and higher cash processing fees and business process outsourcing and IT consulting services, among others. Also, non-interest income included a gain of approximately $\$ 1.7$ million related to the sale of substantially all assets of EVERTEC s health processing division in exchange for an equity participation in the acquiring company.
lower operating expenses by $\$ 1.4$ million, or $3 \%$, primarily due to lower personnel, communications, equipment and other operating expenses; and
higher income tax expense by $\$ 0.5$ million.
Net income for the six months ended June 30, 2008 total $\$ 25.3$ million, an increase of $\$ 11.4$ million, or $82 \%$, compared to $\$ 13.8$ million with the same period in the previous year. These results reflected:
higher non-interest income by $\$ 16.1$ million, or $13 \%$. The results for the six months ended June 30, 2008 included $\$ 7.6$ million in gains on the redemption of Visa stock held by ATH Costa Rica during the first quarter of 2008. Also, there were higher fees related to the volume of transactions processed in the ATM network and POS terminals, cash processing, item processing, and bank applications and credit cards processing fees.
higher operating expenses by $\$ 2.6$ million, or $3 \%$; and
higher income tax expense by $\$ 2.1$ million.

## Banco Popular North America

Banco Popular North America reported a net loss of $\$ 34.3$ million for the quarter ended June 30, 2008, compared to net income of $\$ 8.4$ million for the second quarter of 2007. The main factors that contributed to the quarterly variance in this reportable segment included:
higher net interest income by $\$ 0.4$ million, or less than $1 \%$;
higher provision for loan losses by $\$ 69.2$ million, primarily due to higher net charge-offs in the consumer, mortgage and commercial loan portfolios. The consumer loan portfolio has been impacted by higher losses in home equity lines of credit and second lien mortgage loans, which similar to first mortgage loans, have been unfavorably impacted by the deterioration in the U.S. residential housing market. The increase in the provision for loan losses considers inherent losses in the portfolios evidenced by an increase in non-performing loans in this reportable segment by $\$ 148$ million, when compared to June 30, 2007. The ratio of allowance for loan losses to loans held-in-portfolio for the Banco Popular North America reportable segment was $1.84 \%$ as of June 30, 2008, compared with $0.98 \%$ as of June 30, 2007. The provision for loan losses represented $188 \%$ of net charge-offs for the second quarter of 2008, compared with $121 \%$ of net charge-offs in the same period of 2007. The net charge-offs to average loans held-in-portfolio for the Banco Popular North America operations was $0.43 \%$ for the quarter ended June 30,2008 , compared with $0.11 \%$ in the same quarter of the previous year.
lower non-interest income by $\$ 16.4$ million, or $36 \%$, mainly due to lower gain on sale of loans by $\$ 12.2$ million, primarily by $\$ 14.7$ million at E-LOAN as a result of lower originations and sales due to the discontinuance of certain lines of business and the losses incurred in the second quarter of 2008 related to the

## Table of Contents

lower operating expenses by $\$ 13.7$ million, or $12 \%$. E-LOAN s expenses were reduced by $\$ 18.4$ million principally in business promotion, personnel costs and professional fees. The reduction at E-LOAN was partially offset by higher personnel costs and other operating expenses at the banking subsidiary. Included in other operating expenses were $\$ 3.5$ million in reserves for unfunded loan commitments, primarily related to commercial and home equity lines of credit.
income tax benefit of $\$ 24.8$ million in the first quarter of 2008 due to taxable losses, compared with income tax expense of $\$ 3.9$ million in the second quarter of 2007.
Net loss for the six months ended June 30, 2008 totaled $\$ 36.3$ million, a decrease of $\$ 60.2$ million, compared to net income of $\$ 23.9$ million for the same period in the previous year. These results reflected:
higher net interest income by $\$ 6.1$ million, or $3 \%$;
higher provision for loan losses by $\$ 117.5$ million;
lower non-interest income of $\$ 19.5$ million, or $19 \%$, mainly due to lower gain on sale of loans and valuation adjustments on loans held-for-sale by $\$ 26.1$ million primarily related to E-LOAN. This unfavorable variance was partially offset by the $\$ 12.8$ million gain on the sale of the Texas branches.
lower operating expenses by $\$ 29.7$ million, or $13 \%$; and
income tax benefit of $\$ 28.0$ million for the six months ended June 30 , 2008, compared to income tax expense of $\$ 12.9$ million for the same period in the previous year.

## Popular Financial Holdings

For the quarter ended June 30, 2008, net loss for the reportable segment of Popular Financial Holdings totaled $\$ 35.8$ million, compared to net loss of $\$ 8.1$ million for the second quarter of 2007. Refer to the Restructuring Plans section of this MD\&A for information of the PFH Branch Network Restructuring plan and its impact to the year-to-date results. The main factors that contributed to the quarterly variance included:
lower net interest income by $\$ 39.2$ million, or $84 \%$, primarily due to the reduction in loan levels due to the sale of the loan portfolio to American General in the first quarter of 2008, the recharacterization transaction in December 2007 which resulted in the removal of loans from the statement of condition, and the discontinuance of loan origination activities in its principal loan origination channels, including the closure of the branch network in the first quarter of 2008;
lower provision for loan losses by $\$ 38.0$ million, or $96 \%$, primarily due to lower loan portfolio levels and to the fact that there is no need to establish loan reserves for loans measured at fair value since any credit deterioration on those loans become part of the fair value measurement. The ratio of allowance for loan losses to loans held-in-portfolio for the Popular Financial Holdings reportable segment was $2.57 \%$ as of June 30, 2008, compared with $1.85 \%$ as of June 30, 2007. The provision for loan losses represented $42 \%$ of net charge-offs for the second quarter of 2008, compared with $119 \%$ of net charge-offs in the same period of 2007. The net charge-offs to average loans held-in-portfolio for the Popular Financial Holdings reportable segment was $1.10 \%$ for the quarter ended June 30, 2008, compared with $0.44 \%$ in the same quarter of the previous year.
lower non-interest income by $\$ 55.3$ million, principally due to recognition during the second quarter of 2008 of $\$ 35.9$ million in unfavorable valuation adjustments on the financial instruments measured at fair value. This also includes the effect of losses of $\$ 7.1$ million in the quarter ended June 30,2008 due to fair value adjustments on $\$ 12.3$ million in loans repurchased under payment default indemnification clauses.
lower operating expenses by $\$ 13.3$ million, or $43 \%$, mainly due to lower professional fees, net occupancy expenses, personnel costs, communications and business promotion expenses; and
income tax benefit of $\$ 19.1$ million in the second quarter of 2008, compared with income tax benefit of $\$ 3.6$ million in the second quarter of 2007.
Net loss for the six months ended June 30, 2008 totaled $\$ 31.8$ million, a decrease of $\$ 48.7$ million, or $61 \%$, compared to net loss of $\$ 80.5$ million for the same period in the previous year. These results reflected:
lower net interest income by $\$ 59.4$ million, or $67 \%$;
lower provision for loan losses by $\$ 69.9$ million, or $89 \%$;

## Table of Contents

higher non-interest income by $\$ 50.3$ million, or $99 \%$. The variance in non-interest income consisted of higher gain on sale of loans and valuation adjustments on loans held-for-sale of $\$ 48.3$ million, principally due to the sale of loans to American General, and lower impairment losses on residual interests by $\$ 41.4$ million. These favorable variances were partially offset by $\$ 38.9$ million in SFAS 159 unfavorable valuation adjustments.
lower operating expenses by $\$ 16.0$ million, or $19 \%$; and
lower income tax benefit by $\$ 28.0$ million, or $66 \%$.

## FINANCIAL CONDITION

Refer to the consolidated financial statements included in this report for the Corporation s consolidated statements of condition and to Table A for financial highlights on major line items of the statements of condition. At June 30, 2008, total assets were $\$ 41.7$ billion, compared to $\$ 44.4$ billion at December 31, 2007 and $\$ 47.0$ billion at June 30, 2007.

## Investment securities

A breakdown of the Corporation s investment securities available-for-sale and held-to-maturity is provided in Table F . Notes 5 and 6 to the consolidated financial statements provide additional information by contractual maturity categories and unrealized gains / losses with respect to the Corporation s available-for-sale and held-to-maturity investment securities portfolio. The Corporation holds investment securities primarily for liquidity, yield enhancement and interest rate risk management. The portfolio primarily includes very liquid, high quality debt securities.
TABLE F
Breakdown of Investment Securities Available-for-Sale and Held-to-Maturity

| (In millions) | December |  |  |  | Variance |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ | $\begin{gathered} 31 \\ 2007 \end{gathered}$ | Variance | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  |
| U.S. Treasury securities | \$ 460.8 | \$ 471.1 | (\$ 10.3) | \$ 462.6 | (\$ 1.8) |
| Obligations of U.S. Government sponsored entities | 4,639.8 | 5,893.1 | $(1,253.3)$ | 6,182.1 | $(1,542.3)$ |
| Obligations of Puerto Rico, States and political subdivisions | 311.0 | 178.0 | 133.0 | 186.2 | 124.8 |
| Collateralized mortgage obligations | 1,608.9 | 1,396.8 | 212.1 | 1,532.4 | 76.5 |
| Mortgage-backed securities | 884.0 | 1,010.1 | (126.1) | 960.2 | (76.2) |
| Equity securities | 15.4 | 34.0 | (18.6) | 45.3 | (29.9) |
| Others | 14.9 | 16.5 | (1.6) | 35.1 | (20.2) |
| Total | \$7,934.8 | \$8,999.6 | (\$ 1,064.8) | \$9,403.9 | (\$ 1,469.1) |

The vast majority of these investment securities, or approximately $99 \%$, are rated the equivalent of AAA by the major rating agencies. The mortgage-backed securities ( MBS ) and collateralized mortgage obligations ( CMOs ) are investment grade securities, all of which are rated AAA by at least one of the three major rating agencies as of June 30, 2008. All MBS held by the Corporation and approximately $87 \%$ of the CMOs held as of June 30, 2008 are guaranteed by government sponsored entities.
The decline in the Corporation s available-for-sale and held-to-maturity investment portfolios was mainly associated with the maturities of securities, which were not replaced as they matured during 2007, in part because of the Corporation s strategy to deleverage the balance sheet and reduce lower yielding assets.
The Corporation sold $\$ 2.4$ billion in U.S. agency securities during the quarter ended June 30, 2008 to reduce its vulnerability to declining interest rates. The proceeds were reinvested primarily in U.S. agency securities and, to a lesser extent, mortgage-backed securities, with a longer average duration. As indicated earlier in this MD\&A, this sale generated a capital gain of approximately $\$ 28.3$ million. Before the completion of the transaction, the Corporation had an asset sensitive position, whereby net interest income simulations suggested that a decline in the general level of
interest rates would be expected to exert downward pressure on the Corporation s future net interest income. To mitigate this risk, the Corporation extended the duration of the securities portfolio. The degree of asset sensitivity on the balance sheet was thus reduced with these transactions.

## Table of Contents

## Loan portfolio

Total loans, net of unearned, amounted to $\$ 27.6$ billion as of June 30, 2008, compared with $\$ 29.9$ billion as of December 31, 2007 and $\$ 32.8$ billion as of June 30, 2007. A breakdown of the Corporation s loan portfolio, the principal category of earning assets, is presented in Table G.
TABLE G
Loans Ending Balances


## Loans measured at fair value (SFAS

No. 159):

| Commercial | $\$ 111,823$ | $\$ 111,823$ | $\$ 11,823$ |  |
| :--- | ---: | ---: | ---: | ---: |
| Mortgage |  | 646,535 | 646,535 | 646,535 |
| Consumer |  | 86,534 | 86,534 | 86,534 |
|  |  |  |  |  |
| Total loans measured at fair value | $\$ 844,892$ | $\$ 844,892$ | $\$ 844,892$ |  |

## Loans held-for-sale measured at lower of cost or market:

$\left.\begin{array}{lrrrrrrrr}\text { Commercial } & \$ & 24,023 & \$ & 24,148 & (\$ & 125) & \$ & 39,830\end{array}(\$) 15,807\right)$

Total loans held-for-sale measured at lower of cost or market

* Includes
residential construction

The decrease in mortgage and consumer loans held-in-portfolio from December 31, 2007 to June 30, 2008 was mainly due to the reclassification of certain loans to the category of loans measured at fair value pursuant to the SFAS No. 159 election described in the SFAS No. 159 Fair Value Option Election section of this MD\&A. Table H provides information on the unpaid principal balance, unrealized losses and fair value of the loans measured at fair value as of June 30, 2008.
The reduction in mortgage loans held-in-portfolio was also due to the securitization into FNMA mortgage-backed securities of approximately $\$ 307$ million (UPB) of residential mortgage loans by BPPR in the second quarter of 2008. As indicated previously in the Non-Interest Income section of this MD\&A, $\$ 232$ million of these MBS were sold in the secondary markets during the second quarter of 2008. The sale proceeds were reinvested in U.S. agency securities. The objective of the sale was to reduce the Corporation s level of mortgage loans retained in portfolio and enhance its return on risk-weighted capital.
The increase in construction loans held-to-maturity from December 31, 2007 to June 30, 2008 was principally at the Banco Popular de Puerto Rico reportable segment, which increased by $\$ 106$ million. The growth in the construction loan portfolio included loans to builders and developers of residential real estate and other commercial property.

## Table of Contents

## TABLE H

## Loans Measured at Fair Value

|  | Aggregate <br> unpaid <br> principal <br> balance | Unrealized |  |  |
| :--- | ---: | ---: | ---: | ---: |
| (In thousands) | losses | Fair value |  |  |
| Commercial | $\$ 124,707$ | $(\$ 12,884)$ | $\$ 111,823$ |  |
| Mortgage | 958,285 | $(311,750)$ | 646,535 |  |
| Consumer | 262,581 | $(176,047)$ | 86,534 |  |
|  |  |  |  |  |
| Total loans measured at fair value (SFAS No. 159) | $\$ 1,345,573$ | $(\$ 500,681)$ | $\$ 844,892$ |  |

The reduction in mortgage and consumer loans held-for-sale from the end of 2007 to June 30, 2008 was mainly due to the sale of $\$ 1.4$ billion of PFH s loans to American General on March 1, 2008. The decrease in the lease financing portfolio held-for-sale from December 31, 2007 to June 30, 2008 was principally due to the sale of approximately $\$ 66$ million of lease financings by Popular Equipment Leasing, a subsidiary of BPNA, during 2008.
Similar factors, as previously described, influenced the variances in the different portfolio categories from June 30, 2007 to the same date in 2008. Furthermore, also impacting the decrease in mortgage loans held-for-sale from June 30, 2007 was the PFH loan recharacterization transaction completed in December 2007. Additionally, the reduction is associated with the runoff of existing portfolios and to the downsizing of E-LOAN s wholesale mortgage loan origination business as part of the restructuring plan at that subsidiary in the fourth quarter of 2007.
Table I provides a breakdown of the total consumer loan portfolio, including consumer loans measured at fair value.

## TABLE I

Breakdown of Total Consumer Loans


The reduction in consumer loans from June 30, 2007 to the same date in 2008 was also influenced by the discontinuation of home equity lines of credit and auto loan originations at E-LOAN due to the restructuring plan, and to the sales of auto loan portfolios by E-LOAN during the later part of 2007 and in June 2008. Also, the reduction in auto loans was due to declining overall unit sales in the Puerto Rico market.

## Table of Contents

## Other assets

Table J provides a breakdown of the Other Assets caption presented in the consolidated statements of condition.
TABLE J
Breakdown of Other Assets

|  |  |  | Variance <br> June 30, <br> 2008 <br> Vs. |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |
|  |  |  |  | Variance <br> December <br> 31, | June 30, |

Explanations for the principal variances from December 31, 2007 to June 30, 2008 included the following:
Increase in trade receivables as a result of mortgage-backed securities sold by Popular Mortgage and BPPR prior to quarter end, with settlement date in July 2008.

Increase in net deferred tax assets was primarily due to the deferred tax asset of $\$ 151$ million recorded as of June 30, 2008 related specifically to the SFAS No. 159 fair value option, and increases of $\$ 50$ million related to timing differences in the recognition of the provision for loan losses under GAAP and actual net charge offs under the tax code and $\$ 35$ million related to net operating losses carryforward in the U.S. operations.

The increase in servicing advance requirements was primarily as a result of slower prepayment rates and higher delinquency levels. The Corporation, acting as a servicer in certain PFH securitization transactions, is required under certain servicing agreements to advance its own funds to meet contractual remittance requirements for investors, process foreclosures and pay property taxes and insurance premiums. Funds are also advanced to maintain and market real estate properties on behalf of investors. As the servicer, the Corporation is required to advance funds only to the extent that it believes the advances are recoverable. The advances have the highest standing in terms of repayment priority over payments made to bondholders of each securitization trust. The Corporation funds these advances from several internal and external funding sources.
Principal variances in other assets from June 30, 2007 to the same date in 2008 were mostly due to similar factors as described above. The increase in the net deferred tax asset was also associated with PFH due to certain events that occurred during 2007 which were disclosed in the 2007 Annual Report, such as the impact of the loss on the loan recharacterization transaction and on the valuation of PFH s residual interests since these losses were recognized for
tax purposes in a different period causing a timing difference. Also, the increase was due to the net operating loss carryforwards in certain tax jurisdictions and to the reversal of a deferred tax liability due to the impairment of E-LOAN s trademark.

## Table of Contents

## Deposits, borrowings and capital

The composition of the Corporation s financing to total assets as of June 30, 2008 and December 31, 2007 is included in Table K as follows:
TABLE K
Financing to Total Assets


A breakdown of the Corporation s deposits at period-end is included in Table L.
TABLE L
Deposits Ending Balances


* Includes interest and non-interest bearing demand deposits.

Brokered certificates of deposit ( brokered CDs ) totaled $\$ 2.1$ billion at June 30, 2008, which represented $8 \%$ of the Corporation s total deposits, compared to $\$ 3.1$ billion, or $11 \%$, respectively, at December 31, 2007. Brokered CDs amounted to $\$ 0.6$ billion at June 30, 2007, or $3 \%$ of total deposits. Brokered CDs, which are typically sold through an intermediary to small retail investors, provide access to longer-term funds that are available in the market area and provide the ability to raise additional funds without pressuring retail deposit pricing. One of the strategies followed by
management in response to the unprecedented market disruptions during the later part of 2007 was the utilization of brokered CDs to replace a portion of the exposure to uncommitted lines of credit. Management reduced partially the overall outstanding balance of brokered CDs during the quarter ended June 30, 2008 and financed the reduction with short-term borrowings. The Corporation will place less reliance on this funding source as liquidity conditions permit. The decrease in time deposits from December 31, 2007 to June 30, 2008 included the reduction in brokered certificates of deposit of $\$ 1.0$ billion. Also, the decline in time deposits was due to the sale of BPNA s Texas branches in early 2008, which had approximately $\$ 125$ million in deposits at the sale transaction date. The increase in deposits from June 30, 2007 to the same date in 2008 was influenced principally by the increase in brokered CDs.
Core deposits have historically provided the Corporation with a sizable source of relatively stable and low-cost funds. For purposes of defining core deposits, the Corporation excludes brokered CDs, including those brokered CDs with denominations under $\$ 100,000$. The Corporation s core deposits totaled $\$ 20.2$ billion, or $74 \%$ of total deposits as of June 30, 2008, compared to $\$ 20.1$ billion and $71 \%$ as of December 31, 2007. Core deposits financed $54 \%$ of the Corporation s earning assets as of June 30, 2008, compared to 49\% as of December 31, 2007.

## Table of Contents

The distribution of certificates of deposit with denominations of $\$ 100$ thousand and over as of June 30, 2008, including brokered certificates of deposit, was as follows:
(In millions)

| 3 months or less | $\$ 2,295,054$ |
| :--- | ---: |
| 3 to 6 months | $1,236,074$ |
| 6 to 12 months | 728,210 |
| Over 12 months | 755,500 |

The aggregate amount of overdrafts in demand deposit accounts that were reclassified to loans was $\$ 88$ million as of June 30, 2008, \$144 million as of December 31, 2007 and $\$ 115$ million as of June 30, 2007.
At June 30, 2008, borrowed funds totaled $\$ 10.0$ billion, compared with $\$ 11.6$ billion at December 31, 2007 and $\$ 17.1$ billion at June 30, 2007. Refer to Note 13 to the consolidated financial statements for additional information on the Corporation s borrowings as of such dates. The decline in borrowings from December 31, 2007 to June 30, 2008 was principally impacted by the reduction in financing requirements due to the sale of the PFH loan portfolio to American General, primarily in the form of short-term debt.
The decrease in borrowings from June 30, 2007 to the same date in 2008 was also influenced by the PFH recharacterization transaction effected in December 31, 2007, which reduced securitized debt in the form of bond certificates to investors by approximately $\$ 3.1$ billion. Also, the use of borrowings was decreased substantially at the banking subsidiaries during 2007 due to the reliance on brokered certificates of deposit in the later part of 2007. As indicated earlier, management reduced partially the overall outstanding balance of brokered certificates of deposit during the quarter ended June 30, 2008 and financed the reduction with short-term borrowings. Another strategy implemented by management during the second half of 2007 included the utilization of unpledged liquid assets to raise financing in the repo markets, the proceeds of which were also used to pay off unsecured borrowings. Stockholders equity totaled $\$ 3.7$ billion at June 30, 2008, compared with $\$ 3.6$ billion at December 31, 2007 and $\$ 3.7$ billion at June 30, 2007. Stockholders equity increased $\$ 124$ million from the end of 2007 to June 30, 2008 as a result of the $\$ 400$ million preferred stock offering during this quarter, partially offset by the $\$ 262$ million negative after-tax adjustment to beginning retained earnings due to the transitional adjustment for electing the fair value option, as previously described. Stockholders equity remained stable, compared to June 30, 2007, due to the preferred stock offering and lower unrealized losses in securities available-for-sale, partially offset by the impact of the SFAS 159 adoption and the net taxable losses in the Corporation s U.S. operations. Also, the increase resulting from the preferred stock offering was partially offset by a reduction in retained earnings as a result of the dividends paid.
Refer to the consolidated statements of condition and of stockholders equity included in this Form 10-Q for information on the composition of stockholders equity at June 30, 2008, December 31, 2007 and June 30, 2007. Also, the disclosures of accumulated other comprehensive income (loss), an integral component of stockholders equity, are included in the consolidated statements of comprehensive income (loss).
The average tangible common equity amounted to $\$ 2.5$ billion for the quarter ended June 30, 2008, compared to $\$ 2.8$ billion for the quarter ended December 31, 2007 and $\$ 2.9$ billion for the quarter ended June 30, 2007. Total tangible common equity at period end was $\$ 2.4$ billion at June 30, 2008, compared to $\$ 2.7$ billion at December 31, 2007 and June 30, 2007. The average tangible common equity to average tangible assets ratio was $6.20 \%$ for the quarter ended June 30, 2008, compared with $6.14 \%$ for the quarter ended December 31, 2007 and $6.31 \%$ for the quarter ended June 30, 2007. Tangible common equity consists of total stockholders equity less preferred stock, goodwill and other intangibles.
The Corporation continues to exceed the well-capitalized guidelines under the federal banking regulations. For this quarter, the ratios improved as a result of the $\$ 400$ million preferred stock offering, which qualifies as Tier I capital. The regulatory capital ratios and amounts of total risk-based capital, Tier 1 risk-based capital and Tier 1

## Table of Contents

leverage at June 30, 2008, December 31, 2007, and June 30, 2007 are presented on Table M. As of such dates, BPPR, BPNA and Banco Popular, National Association were well-capitalized.
TABLE M
Capital Adequacy Data

| (Dollars in thousands) | June 30, 2008 | $\begin{gathered} \text { December 31, } \\ 2007 \end{gathered}$ | June 30, 2007 |
| :---: | :---: | :---: | :---: |
| Risk-based capital |  |  |  |
| Tier I capital | \$ 3,376,331 | \$ 3,361,132 | \$ 3,770,991 |
| Supplementary (Tier II) capital | 407,009 | 417,132 | 443,689 |
| Total capital | \$ 3,783,340 | \$ 3,778,264 | \$ 4,214,680 |
| Risk-weighted assets |  |  |  |
| Balance sheet items | \$28,876,581 | \$30,294,418 | \$32,502,007 |
| Off-balance sheet items | 3,271,018 | 2,915,345 | 2,869,633 |
| Total risk-weighted assets | \$32,147,599 | \$33,209,763 | \$35,371,640 |
| Average assets | \$39,626,240 | \$45,842,338 | \$46,150,567 |
| Ratios: |  |  |  |
| Tier I capital (minimum required - $4.00 \%$ ) | 10.50\% | 10.12\% | 10.66\% |
| Total capital (minimum required - $8.00 \%$ ) | 11.77 | 11.38 | 11.92 |
| Leverage ratio * | 8.52 | 7.33 | 8.17 |
| * All banks are required to have a minimum Tier I leverage ratio of $3 \%$ or $4 \%$ of adjusted quarterly average assets, depending on the bank s classification. |  |  |  |

As of June 30, 2008, the capital adequacy minimum requirement for Popular, Inc. was (in thousands): Total Capital of $\$ 2,571,808$, Tier I Capital of $\$ 1,285,904$, and Tier I Leverage of $\$ 1,188,787$ based on a $3 \%$ ratio or $\$ 1,585,050$ based on a $4 \%$ ratio according to the Bank s classification.
OFF-BALANCE SHEET FINANCING ENTITIES
The Corporation, through certain subsidiaries of PFH, conducted a program of asset securitizations that involved the transfer of mortgage loans to a special purpose entity depositor, which in turn transferred those mortgage loans to
different securitization trusts, thus isolating those loans from the Corporation $s$ assets. The securitization trusts that constituted qualified special purpose entities ( QSPEs ) under the provisions of SFAS No. 140 and are associated with securitizations that qualified for sale accounting under SFAS No. 140 are not consolidated in the Corporation s financial statements. The investors in these off-balance sheet securitizations have no recourse to the Corporation s assets or revenues. The Corporation s creditors have no recourse to any assets or revenues of the special purpose entity depositor, or the securitization trust funds. As of June 30, 2008 and December 31, 2007, the Corporation had mortgage loans of approximately $\$ 5.0$ billion and $\$ 5.4$ billion, respectively, in securitization transactions that qualified for off-balance sheet treatment. These transactions had liabilities in the form of debt securities payable to investors from the assets inside each securitization trust of approximately $\$ 4.7$ billion and $\$ 5.1$ billion as of June 30, 2008 and December 31, 2007, respectively. The Corporation retained servicing responsibilities and certain subordinated interests in these securitizations in the form of residual interests. Their value is subject to credit, prepayment and interest rate risks on the transferred financial assets. The servicing rights and residual interests retained by the Corporation are recorded in the statement of condition as of June 30, 2008 at fair value.

## CREDIT RISK MANAGEMENT AND LOAN QUALITY

The allowance for loan losses is management s estimate of credit losses inherent in the loans held-in-portfolio at the balance sheet date. Table N summarizes the detail of the changes in the allowance for loan losses, including charge-offs and recoveries by loan category for the quarters and six months ended June 30, 2008 and 2007.

Edgar Filing: POPULAR INC - Form 10-Q

## Table of Contents

TABLE N
Allowance for Loan Losses and Selected Loan Losses Statistics

|  | Second Quarter |  |  | Six months ended June 30, |  |  |  |
| :--- | :---: | :---: | :---: | ---: | ---: | ---: | ---: |
| (Dollars in thousands) | 2008 | 2007 | Variance | 2008 | 2007 | Variance |  |
|  |  |  |  |  |  |  |  |
| Balance at beginning of <br> period | $\$ 579,379$ | $\$ 541,748$ | $\$ 37,631$ | $\$ 548,832$ | $\$ 522,232$ | $\$ 26,600$ |  |
| Provision for loan losses | 190,640 | 115,167 | 75,473 | 358,862 | 211,513 | 147,349 |  |
|  | 770,019 | 656,915 | 113,104 | 907,694 | 733,745 | 173,949 |  |

Losses charged to the
allowance:
Commercia
Construction
Lease financing
Mortgage
Consumer

| 43,806 | 21,532 | 22,274 | 75,884 | 38,860 | 37,024 |
| ---: | ---: | :---: | ---: | :---: | :---: |
| 5,770 |  | 5,770 | 5,770 |  | 5,770 |
| 5,362 | 6,200 | $(838)$ | 10,994 | 12,608 | $(1,614)$ |
| 11,917 | 23,492 | $(11,575)$ | 22,879 | 44,100 | $(21,221)$ |
| 63,475 | 55,481 | 7,994 | 125,007 | 102,688 | 22,319 |
|  |  |  |  |  |  |
| 130,330 | 106,705 | 23,625 | 240,534 | 198,256 | 42,278 |

Recoveries:
Commercial

| 3,821 | 3,487 | 334 | 6,840 | 6,969 | $(129)$ |
| ---: | ---: | :---: | ---: | ---: | ---: |
| 804 | 2,510 | $(1,706)$ | 1,506 | 4,508 | $(3,002)$ |
| 803 | 706 | 97 | 1,247 | 851 | 396 |
| 8,288 | 7,934 | 354 | 16,525 | 17,030 | $(505)$ |
| 13,716 | 14,637 | $(921)$ | 26,118 | 29,358 | $(3,240)$ |

Net loans charged-off:

| Commercial | 39,985 | 18,045 | 21,940 | 69,044 | 31,891 | 37,153 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Construction | 5,770 |  | 5,770 | 5,770 |  | 5,770 |
| Lease financing | 4,558 | 3,690 | 868 | 9,488 | 8,100 | 1,388 |
| Mortgage | 11,114 | 22,786 | $(11,672)$ | 21,632 | 43,249 | $(21,617)$ |
| Consumer | 55,187 | 47,547 | 7,640 | 108,482 | 85,658 | 22,824 |
|  | 116,614 | 92,068 | 24,546 | 214,416 | 168,898 | 45,518 |
|  |  |  |  |  |  |  |
| Write-downs related to <br> loans transferred to loans <br> held-for-sale |  |  |  |  |  |  |
| Adjustment due to the <br> adoption of SFAS |  |  | 675 | 3,617 |  | 3,617 |
| No. 159 |  |  |  |  |  | 36,931 |
|  |  |  |  |  |  |  |
| Balance at end of period | $\$ 652,730$ | $\$ 564,847$ | $\$ 87,883$ | $\$ 652,730$ | $\$ 564,847$ | $\$ 87,883$ |

Edgar Filing: POPULAR INC - Form 10-Q
Ratios:
Net charge-offs to average loans

| held-in-portfolio <br> Provision to net <br> charge-offs | $1.76 \%$ | $1.16 \%$ | $1.62 \%$ | $1.06 \%$ |
| :--- | :---: | :---: | :---: | :---: |
|  | 1.63 x | 1.25 x | 1.67 x | 1.25 x |

## Table of Contents

Table O presents annualized net charge-offs to average loans held-in-portfolio for the quarters and six months ended June 30, 2008 and 2007 by loan category.
TABLE 0
Annualized Net Charge-offs to Average Loans Held-in-Portfolio

|  | Quarter ended June 30, |  | Six months ended June 30, |  |
| :--- | :--- | :--- | :--- | :--- |
|  | 2008 | 2007 | 2008 | 2007 |
|  |  |  |  |  |
| Commercial | $1.17 \%$ | $0.54 \%$ | $1.02 \%$ | $0.48 \%$ |
| Construction | 1.13 |  | 0.58 |  |
| Lease financing | 1.65 | 1.24 | 1.72 | 1.35 |
| Mortgage | 0.93 | 0.87 | 0.90 | 0.80 |
| Consumer | 4.49 | 3.61 | 4.37 | 3.28 |
|  |  |  |  | $1.62 \%$ |
|  |  | $1.76 \%$ | $1.16 \%$ | $1.06 \%$ |

The increase in commercial loans net charge-offs for the quarter ended June 30, 2008 compared to the same quarter in the previous year was mostly associated with continued deterioration in the economic conditions in Puerto Rico which is experiencing a recessionary cycle. Also, the U.S. mainland portfolio experienced deterioration. Credit deterioration trends have been reflected across all industry sectors. The ratio of commercial loans net charge-offs to average commercial loans held-in-portfolio in the Banco Popular de Puerto Rico reportable segment was $1.71 \%$ for the quarter ended June 30, 2008, compared to $0.68 \%$ for the second quarter of 2007. Also, an increase was experienced in the Banco Popular North America reportable segment, which had a ratio of $0.48 \%$ for the second quarter of 2008, compared with $0.29 \%$ for the same quarter in the previous year. Commercial net charge-offs recorded during the second quarter of 2008 were mainly related to credits with specific reserves under SFAS No. 114.
The increase in construction loans net charge-offs for the quarter ended June 30, 2008 compared to the same quarter in the previous year was related to the Corporation s U.S. operations. Despite the increased volume of construction loans in non-performing status during 2008 as explained in the Non-performing Assets section in this MD\&A, principally in Puerto Rico, there have not been any construction loan charge-offs in the Puerto Rico operations. Management has identified construction loans considered impaired under SFAS No. 114 and established specific reserves based on the value of the collateral.
The increase in the lease financing net charge-offs to average lease financing loans held-in-portfolio ratio for the second quarter of 2008, when compared with the second quarter in the previous year, was associated with higher delinquencies in the Puerto Rico operations due to the current recessionary environment, and also higher charge-offs in the Corporation s U.S. mainland operations.
Mortgage loans net charge-offs as a percentage of average mortgage loans held-in-portfolio did not reflect a sharp increase when comparing this credit indicator for the second quarter of 2008 to that same quarter in the previous year even when the Corporation was greatly impacted throughout 2007 by the slowdown in the housing sector and experienced higher delinquency levels in the U.S. mainland primarily in the Corporation s U.S. subprime mortgage loan portfolio. The net charge-offs to average mortgage loans held-in-portfolio credit indicator reflects a substantial reduction from that indicator reported for the fourth quarter of 2007 which was $2.25 \%$. This decline was influenced by a lower subprime mortgage loan portfolio outstanding for PFH as a result of the loan recharacterization transaction completed in late December 2007, the sale to American General in March 2008 and the election to measure the PFH loan portfolio described previously at fair value. For the loans accounted at fair value, loan losses are not recorded as part of the changes in the allowance for loan losses. Any unfavorable changes in their fair value are reported through earnings in the Losses from changes in fair value related to instruments measured at fair value pursuant to SFAS No. 159 caption of the consolidated statement of operations.
Consumer loans net charge-offs as a percentage of average consumer loans held-in-portfolio rose mostly due to higher delinquencies in the U.S. mainland. Consumer loans net charge-offs in the BPNA reportable segment rose for the
quarter ended June 30, 2008 when compared with the same quarter in the previous year by $\$ 17.2$ million. The ratio of consumer loans net charge-offs to average consumer loans held-in-portfolio in the Banco Popular North America reportable segment was $6.08 \%$ for the quarter ended June 30, 2008, compared to $1.39 \%$ for the second

## Table of Contents

quarter of 2007. This increase was principally related to home equity lines of credit and second lien mortgage loans which are categorized by the Corporation as consumer loans. A home equity line of credit is a loan secured by a primary residence or second home to the extent of the excess of fair market value over the debt outstanding for the first mortgage. As indicated in the SFAS No. 159 Fair Value Option Election section of this MD\&A, the deterioration in the delinquency profile and the declines in property values have negatively impacted charge-offs. E-LOAN represented approximately $\$ 11.7$ million of that increase in the net charge-offs in consumer loans held-in-portfolio for the BPNA reportable segment. With the downsizing of E-LOAN in late 2007, this subsidiary ceased originating these types of loans. The increase in net charge-offs for the quarter in the BPNA reportable segment was mostly offset by a decrease of $\$ 10.0$ million in PFH due the shutdown of the consumer loan origination activities at that subsidiary.

## NON-PERFORMING ASSETS

Non-performing assets include past-due loans that are no longer accruing interest, renegotiated loans and real estate property acquired through foreclosure. A summary, including certain credit quality metrics, is presented in Table P for loans, excluding loans measured at fair value, and Table Q for loans measured at fair value pursuant to the SFAS No. 159 fair value option. For a summary of the Corporation s policy for placing loans on non-accrual status, refer to the sections of Loans and Allowance for Loan Losses included in Note 1 to the audited consolidated financial statements included in Popular, Inc. s 2007 Annual Report.
Upon adoption of SFAS No. 159, the Corporation elected to account for interest income as part of net interest income in the consolidated statement of operations. Accrued interest receivable on loans measured at fair value (SFAS No. 159) is included as part of the fair value of the loans. For loans held-in-portfolio and loans held-for-sale measured at lower of cost or market, accrued interest receivable is presented separately in the consolidated statement of condition.
TABLE P
Non-Performing Assets, Excluding Loans Measured at Fair Value


Total non-performing assets, excluding loans $\begin{array}{lllllll}\text { measured at fair value } & \$ 1,026,180 & \$ 852,082 & \$ 174,098 & \$ 971,110 & \$ 55,070\end{array}$

Accruing loans past due 90 days or more, excluding loans $\begin{array}{llllllll}\text { measured at fair value } & \$ 114,834 & \$ 109,569 & \$ & 5,265 & \$ 104,497 & \$ & 10,337\end{array}$

Non-performing
assets, excluding loans measured at fair value, to total assets
Allowance for loan
losses to loans held-

| in-portfolio | 2.47 | 1.96 | 1.76 |
| :--- | :--- | :--- | :--- |

Allowance for loan
losses to
non-performing assets, excluding loans
measured at fair value (SFAS No. 159)
Allowance for loan
losses to
non-performing loans, excluding loans measured at fair value (SFAS No. 159) 70.69 71.21
63.61
64.41
2.07\%

## Table of Contents

TABLE Q
Non-Performing Loans Measured at Fair Value

|  |  | Unpaid <br> principal |  |
| :--- | :---: | ---: | :---: |
|  | Fair value as <br> of | balance as of <br> June 30,2008 | Unrealized <br> losses |
| (Dollars in thousands) | June 30, 2008 |  |  |

Non-performing loans measured at fair value to loans measured at fair value
$13.07 \%$
The allowance for loan losses increased by $\$ 104$ million from December 31, 2007 to June 30, 2008. The increase is the net result of additional reserves for specific commercial loans considered impaired, primarily construction loans, and higher reserves for U.S. consumer loan portfolios (mainly home equity lines of credit), offset by the reduction in reserves related to PFH s loan portfolio accounted at fair value. Refer to Table Q for non-performing loans measured at fair value.
Non-performing commercial and construction loans held-in-portfolio increased from December 31, 2007 to June 30, 2008 by $\$ 245$ million, primarily in Banco Popular de Puerto Rico reportable segment by $\$ 219$ million. During the quarter ended March 31, 2008, the Corporation placed in non-performing status its participation of $\$ 51$ million in a syndicated commercial loan collateralized by a marina, commercial real estate, and a high-end apartment complex in the U.S. Virgin Islands. The Corporation is a participant, with two other financial institutions, in a syndicated financing for a total of approximately $\$ 110$ million. The lenders and borrowers are currently in negotiations for the restructuring of the loan; however, no assurance can be given that the loan will be successfully restructured. The Corporation classified this loan relationship as impaired under SFAS No. 114 and established a specific reserve of $\$ 32$ million based on a third-party appraisal of value of the related collateral less estimated cost to sell. During the quarter ended June 30, 2008, the Corporation also placed in non-performing status a construction loan of $\$ 47$ million and classified this credit as impaired under SFAS No. 114. Management established a specific reserve of $\$ 5$ million based on the value of the collateral less estimated cost to sell. The allowance for loan losses for commercial and construction credits has been increased based on proactive identification of risk and thorough borrower analysis. Historically, the Corporation s loss experience with real estate construction loans has been relatively low due the sufficiency of the underlying real estate collateral. In the current stressed housing market, the value of the collateral securing the loan has become one of the most important factors in determining the amount of loss incurred and the appropriate level of allowance for loan losses. Management has increased the allowance for loan losses for construction mainly through specific reserves for the loans considered impaired under SFAS No. 114.
The reduction in non-performing mortgage loans held-in-portfolio from December 31, 2007 to June 30, 2008 was associated in part to the reclassification of a substantial portion of PFH s mortgage loan portfolio to loans measured at fair value, which are disclosed in Table Q. This was offset in part by increases in non-performing mortgage loans in both Banco Popular de Puerto Rico and Banco Popular North America reportable segments. Mortgage loans net

## Edgar Filing: POPULAR INC - Form 10-Q

charge-offs in the Puerto Rico operations for the quarter and six months ended June 30, 2008 remained stable compared to the same quarter in the previous year. Banco Popular de Puerto Rico reportable segment s mortgage loan portfolio averaged approximately $\$ 2.9$ billion for the six months ended June 30, 2008. The mortgage loans net charge-offs in this segment amounted to $\$ 0.8$ million for the six months ended June 30, 2008. On the other hand, the mortgage loans net charge-offs in the Banco Popular North America operations rose by approximately $\$ 14.7$ million when comparing results for the six-month periods ended June 30, 2008 and 2007. This increase was related to the slowdown in the United States housing sector. Refer to the Overview of Mortgage Loan Exposure section later in this MD\&A for further information on BPNA s mortgage loan portfolio.

## Table of Contents

Non-performing consumer loans held-in-portfolio increased as of June 30, 2008 when compared with December 31, 2007 despite the impact of the reclassification of PFH s consumer loan portfolio to loans measured at fair value. The increase was associated with the Banco Popular North America reportable segment, principally E-LOAN which showed an increase of $\$ 10$ million. The increase in the U.S. mainland non-performing consumer loans is mainly attributed to the home equity lines of credit and second lien mortgage loans which are categorized by the Corporation as consumer loans. With the downsizing of E-LOAN in late 2007, this subsidiary ceased originating these types of loans. Regarding the consumer loan portfolio at the Banco Popular de Puerto Rico reportable segment, the Corporation has seen signs of stabilization in terms of delinquency levels. Nevertheless, the continued deterioration in the economic conditions in Puerto Rico may adversely impact the performance of this portfolio.
Other real estate, which represents real estate property acquired through foreclosure, increased by $\$ 21$ million from December 31, 2007 to June 30, 2008, principally in Banco Popular North America reportable segment by $\$ 18$ million. With the slowdown in the housing market, there is a continued economic deterioration in certain geographic areas, which also has a softening effect on the market for resale of repossessed real estate properties. Defaulted loans have increased, and these loans move through the default process to the other real estate classification. The combination of increased flow of defaulted loans from the loan portfolio to other real estate owned and the slowing of the liquidation market has resulted in an increase in the number of units on hand.
Accruing loans past due 90 days or more are composed primarily of credit cards, FHA / VA and other insured mortgage loans, and delinquent mortgage loans included in the Corporation s financial statements pursuant to GNMA s buy-back option program. Under SFAS No. 140, servicers of loans underlying Ginnie Mae mortgage-backed securities must report as their own assets the defaulted loans that they have the option to purchase, even when they elect not to exercise that option. Also, accruing loans past due 90 days or more include residential conventional loans purchased from other financial institutions that, although delinquent, the Corporation has received timely payment from the sellers / servicers, and, in some instances, have partial guarantees under recourse agreements.
The allowance for loan losses, which represents management s estimate of credit losses inherent in the loan portfolio, is maintained at a sufficient level to provide for these estimated loan losses based on evaluations of inherent risks in the loan portfolios. The Corporation s management evaluates the adequacy of the allowance for loan losses on a monthly basis. In this evaluation, management considers current economic conditions and the resulting impact on Popular s loan portfolio, the composition of the portfolio by loan type and risk characteristics, historical loss experience, loss volatility, results of periodic credit reviews of individual loans, regulatory requirements and loan impairment measurement, among other factors. The increase in the Corporation s allowance level as of June 30, 2008 reflects the prevailing negative economic outlook, and specific reserves for commercial and construction loans considered impaired under SFAS No. 114.
The Corporation s methodology to determine its allowance for loan losses is based on SFAS No. 114, Accounting by Creditors for Impairment of a Loan (as amended by SFAS No. 118) and SFAS No. 5, Accounting for Contingencies. Under SFAS No. 114, commercial and construction loans over a predetermined amount are identified for evaluation on an individual basis, and specific reserves are calculated based on impairment analyses. SFAS No. 5 provides for the recognition of a loss contingency for a group of homogeneous loans, which are not individually evaluated under SFAS No. 114, when it is probable that a loss has been incurred and the amount can be reasonably estimated. To determine the allowance for loan losses under SFAS No. 5, the Corporation uses historical net charge-offs and volatility experience segregated by loan type and legal entity. Refer to the 2007 Annual Report for additional information on the Corporation s methodology for assessing the adequacy of the allowance for loan losses. Under SFAS No. 114, the Corporation considers a commercial loan to be impaired when the loan amounts to $\$ 250,000$ or more and interest and / or principal is past due 90 days or more, or, when the loan amounts to $\$ 500,000$ or more and based on current information and events, management considers that the debtor will be unable to pay all amounts due according to the contractual terms of the loan agreement.

## Table of Contents

The Corporation s recorded investment in impaired commercial loans and the related valuation allowance calculated under SFAS No. 114 as of June 30, 2008, December 31, 2007 and June 30, 2007 were:

| (In millions) | June 30, 2008 |  | December 31, 2007 |  | June 30, 2007 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Recorded <br> Investment | Valuation Allowance | Recorded <br> Investment | Valuation Allowance | Recorded Investment | Valuation Allowance |
| Impaired loans: |  |  |  |  |  |  |
| Valuation allowance required | \$435.4 | \$123.1 | \$174.0 | \$54.0 | \$156.6 | \$40.7 |
| No valuation allowance required | 212.4 |  | 147.7 |  | 119.5 |  |
| Total impaired loans | \$647.8 | \$ 123.1 | \$321.7 | \$54.0 | \$276.1 | \$40.7 |

With respect to the $\$ 212.4$ million portfolio of impaired commercial loans (including construction) for which no allowance for loan losses was required as of June 30, 2008, management followed SFAS No. 114 guidance. As prescribed by SFAS No. 114, when a loan is impaired, the measurement of the impairment may be based on: (1) the present value of the expected future cash flows of the impaired loan discounted at the loan s original effective interest rate; (2) the observable market price of the impaired loan; or (3) the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The $\$ 212.4$ million impaired commercial loans were collateral dependent loans in which management performed a detailed analysis based on the fair value of the collateral less estimated costs to sell and determined that the collateral was deemed adequate to cover any losses as of June 30, 2008.
Average impaired loans during the second quarter of 2008 and 2007 were $\$ 549$ million and $\$ 259$ million, respectively. The Corporation recognized interest income on impaired loans of $\$ 2.0$ million and $\$ 2.1$ million for the quarters ended June 30, 2008 and June 30, 2007 and $\$ 3.6$ million and $\$ 4.2$ million for the six months ended on those same dates, respectively.
In addition to the non-performing loans included in Tables P and Q , there were $\$ 150$ million of loans as of June 30, 2008, which in management s opinion are currently subject to potential future classification as non-performing and are considered impaired under SFAS No. 114. As of December 31, 2007 and June 30, 2007, these potential problem loans approximated $\$ 50$ million and $\$ 99$ million, respectively.
Under standard industry practice, closed-end consumer loans are not customarily placed on non-accrual status prior to being charged-off. Excluding the closed-end consumer loans from non-accruing, adjusted non-performing assets would have been $\$ 1.1$ billion as of June 30, 2008, $\$ 803$ million as of December 31, 2007 and $\$ 929$ million as of June 30, 2007.
Commitments to extend credit, which include credit card lines, commercial lines of credit, and other unused credit commitments, amounted to $\$ 8$ billion as of June 30, 2008. Commercial letters of credit and stand-by letters of credit amounted to $\$ 21$ million and $\$ 163$ million, respectively, as of June 30, 2008.
The Corporation maintains a reserve of approximately $\$ 10.1$ million for potential losses associated with unfunded loan commitments related to commercial and consumer lines of credit. The estimated reserve is principally based on the expected draws on these facilities using historical trends and the application of the corresponding reserve factors determined under the Corporation s allowance for loan losses methodology. This reserve for unfunded exposures remains separate and distinct from the allowance for loan losses and is reported as part of other liabilities in the consolidated statement of condition.
Geographical and government risk

As explained in the 2007 Annual Report, the Corporation is exposed to geographical and government risk. The Corporation s assets and revenue composition by geographical area and by business segment reporting are presented in Note 24 to the consolidated financial statements.

## Table of Contents

As of June 30, 2008, the Corporation had $\$ 971$ million of credit facilities granted to or guaranteed by the Puerto Rico Government and its political subdivisions, of which $\$ 175$ million are uncommitted lines of credit. Of these total credit facilities granted, $\$ 798$ million in loans were outstanding as of June 30, 2008. A substantial portion of the Corporation s credit exposure to the Government of Puerto Rico is either collateralized loans or obligations that have a specific source of income or revenues identified for their repayment. Some of these obligations consist of senior and subordinated loans to public corporations that obtain revenues from rates charged for services or products, such as water and electric power utilities. Public corporations have varying degrees of independence from the central Government and many receive appropriations or other payments from the central Government. The Corporation also has loans to various municipalities for which the good faith, credit and unlimited taxing power of the applicable municipality has been pledged to their repayment. These municipalities are required by law to levy special property taxes in such amounts as shall be required for the payment of all of its general obligation bonds and loans. Another portion of these loans consists of special obligations of various municipalities that are payable from the basic real and personal property taxes collected within such municipalities. The full faith and credit obligations of the municipalities have a first lien on the basic property taxes.
Furthermore, as of June 30, 2008, the Corporation had outstanding $\$ 311$ million in Obligations of Puerto Rico, States and Political Subdivisions as part of its investment portfolio. Refer to Notes 5 and 6 to the consolidated financial statements for additional information. Of that total, $\$ 55$ million is exposed to the creditworthiness of the Puerto Rico Government and its municipalities. Of that portfolio, $\$ 288$ million are in the form of Puerto Rico Commonwealth Appropriation Bonds, which are currently rated Ba1, one notch below investment grade, by Moody s, while Standard \& Poor s Rating Services rates them as investment grade.

## Overview of Mortgage Loan Exposure

Given the instability in the residential housing sector, primarily in subprime mortgage loans, Table R provides information on the Corporation s mortgage loan exposure (for loans held-in-portfolio, and excluding loans held-for-sale measured at lower of cost or market and loans measured at fair value) as of June 30, 2008. Subprime mortgage loans refer to mortgage loans made to individuals with a $\mathrm{FICO}^{\circledR}$ score of 660 or below. $\mathrm{FICO}^{\circledR}$ scores are used as an indicator of the probability of default for loans.
TABLE R
Mortgage Loans Exposure

| (In millions) | Prime loans | Subprime <br> loans | Total |
| :--- | :---: | :---: | ---: |
| Banco Popular de Puerto Rico | $\$ 968$ | $\$ 1,160$ | $\$ 2,128$ |
| Banco Popular North America: |  |  |  |
| - Banco Popular North America | 469 | 1,183 | 1,652 |
| - E-LOAN | 58 | 13 | 71 |
| Popular Financial Holdings | 79 | 89 | 168 |
| Sub-total | $\$ 1,574$ | $\$ 2,445$ | $\$ 4,019$ |
| Others not classified as prime or subprime loans |  |  | 634 |
| Total |  |  | $\$ 4,653$ |

Mortgage loans held-in-portfolio that are considered subprime under the above definition for the Banco Popular de Puerto Rico reportable segment approximated $43 \%$ of its total mortgage loans held-in-portfolio as of June 30, 2008 and $42 \%$ as of December 31, 2007. The Corporation, however, believes that the particular characteristics of BPPR s subprime portfolio limit its exposure under current market conditions. BPPR s subprime loans are fixed-rate fully amortizing, full-documentation loans that do not have the level of layered risk associated with subprime loans offered by certain major U.S. mortgage loan originators. While deteriorating economic conditions have impacted the
mortgage delinquency rates in Puerto Rico increasing the levels of non-accruing mortgage loans, BPPR has not to date experienced significant increases in losses. The annualized ratio of mortgage loans net charge-offs to average mortgage loans held-in-portfolio was $0.05 \%$ for the six months ended June 30, 2008, compared with $0.04 \%$ for the year ended December 31, 2007.

## Edgar Filing: POPULAR INC - Form 10-Q

## Table of Contents

BPNA s mortgage loans held-in-portfolio considered subprime under the above definition, excluding E-LOAN, approximated $72 \%$ of its total mortgage loans held-in-portfolio as of June 30, 2008, compared with $71 \%$ as of December 31, 2007. This portfolio has principally two products either 7/1 ARMs (fixed-rate interest until end of year seven in which interest rate begins to reset annually until maturity) or 30-year fixed-rate mortgages that do not have the level of layered risk associated with subprime loans offered by certain major U.S. mortgage loan originators. For example, BPNA s subprime mortgage loan portfolio has minimal California market exposure, loans are underwritten to the fully indexed rate, and there are no interest-only, piggybacks or option ARM loans (Refer to the Glossary included in the 2007 Annual Report for general descriptions of these loan types). Furthermore, the loans are $100 \%$ owner occupied. Also, the first interest rate reset on the 7/1 ARMs is not until 2012. Deteriorating economic conditions in the U.S. mainland housing market have impacted the mortgage industry delinquency rates. The non-accruing loans to loans held-in-portfolio ratio for BPNA s subprime mortgage loans was $4.45 \%$ as of June 30, 2008, compared with $3.67 \%$ as of December 31, 2007. The annualized ratio of mortgage loans net charge-offs to average mortgage loans held-in-portfolio for this subprime portfolio was $2.70 \%$ for the six months ended June 30, 2008, compared with $1.28 \%$ for the year ended December 31, 2007. As a result of higher delinquency and net charge-offs experienced, BPNA recorded a higher provision for loan losses in the first six months of 2008 to cover for inherent losses in this portfolio. The average loan-to-value ( LTV ) for BPNA s subprime mortgage loans held-in-portfolio as of June 30, 2008 was $86 \%$. Effective late December 2007, BPNA launched several initiatives designed to reduce the overall credit exposure in the portfolio that involve the purchase, by either the borrower or BPNA, of private mortgage insurance. BPNA will not originate subprime mortgage loans with a loan-to-value higher than $85 \%$ without private mortgage insurance. This insurance is a financial guaranty in which an insurer assumes a portion of the lender s risk in making a mortgage loan, normally the top portion of the mortgage (i.e. the top $10 \%$ of a loan).
Mortgage loans held-in-portfolio for PFH, excluding Popular FS, that are considered subprime approximated $46 \%$ of its total mortgage loans held-in-portfolio as of June 30, 2008, compared with $73 \%$ as of December 31, 2007. As indicated previously, $\$ 647$ million of PFH s mortgage loan portfolio is measured at fair value, thus the expected cumulative losses for the estimated lifetime of the portfolio are included in its fair value. As a result, management has not included these loans as part of the disclosure in Table Q, which considers only those loans for which an allowance for loan losses has been established only in consideration of inherent losses in the portfolio. The annualized ratio of mortgage loans net charge-offs to average mortgage loans held-in-portfolio for PFH was $2.75 \%$ for the six months ended June 30, 2008.

## Item 3. Quantitative and Qualitative Disclosures About Market Risk MARKET RISK

Market risk is the risk of loss arising from volatility in the fair value of financial instruments or other assets due to changes in interest rates, currency exchange rates, prices, market volatilities and liquidity. The financial results and capital levels of Popular, Inc. are constantly exposed to market risk.
As indicated in Note 2 to the consolidated financial statements and in section SFAS No. 159 Fair Value Option Election in this MD\&A, the Corporation elected to measure at fair value certain loans and borrowings outstanding at January 1, 2008 pursuant to the fair value option provided by SFAS No. 159. As a result, net gain or loss attributable to changes in the fair value of these loans and borrowings are included in the Corporation s consolidated statement of operations. Market factors, such as liquidity, changes in interest rates and the availability of credit, impact the fair value of these loans and borrowings. For example, because the market value of an obligation with a fixed interest rate generally decreases when prevailing interest rates rise, significant increases in interest rates will reduce the fair value of these loans and borrowings, and result in losses. Similarly, to the extent that portfolios of similar assets are sold by others at prices different than the value at which the Corporation carries these loans and borrowings, including as a result of liquidity factors and lack of availability of credit, those sales are taken into consideration when the Corporation measures the fair value of these loans and borrowings, and may result in gains or losses. Therefore, the adoption of the fair value option provided by SFAS No. 159 for these loans and borrowings has increased market risk. Interest rate risk ( IRR ), a component of market risk, is the exposure to adverse changes in net interest income due to changes in interest rates, which can be affected by the shape and the slope of the yield curves to which the

## Edgar Filing: POPULAR INC - Form 10-Q

## Table of Contents

financial products of the Corporation are related. Management considers IRR a predominant market risk in terms of its potential impact on profitability or market value. IRR may occur for one or more reasons, such as the maturity or repricing of assets and liabilities at different times, changes in credit spreads, changes in short and long-term market interest rates, or the maturity of assets or liabilities may be shortened or lengthened as interest rates change.
Depending on the duration and repricing characteristics of the Corporation $s$ assets, liabilities and off-balance sheet items, changes in interest rates could either increase or decrease the level of net interest income. In addition, interest rates may have an indirect impact on loan demand, credit losses, loan origination volume, the value of the Corporation s investment securities holdings, including residual interests, gains and losses on sales of securities and loans, the value of mortgage servicing rights, and other sources of earnings.
The techniques for measuring the potential impact of the Corporation s exposure to market risk from changing interest rates, which were described in the 2007 Annual Report, have remained substantially constant from the end of 2007. The Corporation maintains a formal asset and liability management process to quantify, monitor and control interest rate risk and to assist management in maintaining stability in the net interest margin under varying interest rate environments. Management employs a variety of measurement techniques including the use of an earnings simulation model to analyze the net interest income sensitivity to changing interest rates. Sensitivity analysis is calculated on a monthly basis using a simulation model which incorporates actual balance sheet figures detailed by maturity and interest yields or costs. It also incorporates assumptions on balance sheet growth and possible changes in its composition, estimated prepayments in accordance with projected interest rates, pricing and maturity expectations on new volumes and other non-interest related data. Simulations are processed using various interest rate scenarios to determine potential changes to the future earnings of the Corporation. The asset and liability management group also performs validation procedures on various assumptions used as part of the sensitivity analysis as well as validations of results on a monthly basis. Due to the importance of critical assumptions in measuring market risk, the risk models incorporate third-party developed data for critical assumptions such as prepayment speeds on mortgage-related products, estimates on the duration of the Corporation s deposits and interest rate scenarios.
Computations of the prospective effects of hypothetical interest rate changes are based on many assumptions, including relative levels of market interest rates, interest rate spreads, loan prepayments and deposit decay. Thus, they should not be relied upon as indicative of actual results. Furthermore, the computations do not contemplate actions that management could take to respond to changes in interest rates. By their nature, these forward-looking computations are only estimates and may be different from what actually may occur in the future.
Based on the results of the sensitivity analyses as of June 30, 2008, the Corporation s net interest income for the next twelve months is estimated to increase by $\$ 34.3$ million in a hypothetical 200 basis points rising rate scenario, and the change for the same period, utilizing a similar hypothetical decline in the rate scenario, is an estimated decrease of $\$ 28.1$ million. Both hypothetical rate scenarios consider the gradual change to be achieved during a twelve-month period from the prevailing rates as of June 30, 2008.
The Corporation maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in net interest income or market value that are caused by interest rate volatility. The market value of these derivatives is subject to interest rate fluctuations and, as a result, could have a positive or negative effect in the Corporation s net interest income. Refer to Note 9 to the consolidated financial statements for further information on the Corporation $s$ derivative instruments.
The Corporation conducts business in certain Latin American markets through several of its processing and information technology services and products subsidiaries. Also, it holds interests in Consorcio de Tarjetas Dominicanas, S.A. ( CONTADO ) and Centro Financiero BHD, S.A. ( BHD ) in the Dominican Republic. Although not significant, some of these businesses are conducted in the country s foreign currency. The resulting foreign currency translation adjustment, from operations for which the functional currency is other than the U.S. dollar, is reported in accumulated other comprehensive income (loss) in the consolidated statements of condition, except for highly-inflationary environments in which the effects are included in other operating income in the consolidated statements of operations. As of June 30, 2008, the Corporation had approximately $\$ 36$ million in an unfavorable foreign currency translation adjustment as part of accumulated other comprehensive loss, compared with

## Table of Contents

$\$ 35$ million as of December 31, 2007 and $\$ 34$ million as of June 30, 2007, respectively, also unfavorable.

## LIQUIDITY

For a financial institution, such as the Corporation, liquidity risk may arise whenever the institution cannot generate enough cash from either assets or liabilities to meet its obligations when they become due, without incurring unacceptable losses. Cash requirements for a financial institution are primarily made up of deposit withdrawals, contractual loan funding, the repayment of borrowings as they mature and the ability to fund new and existing investments as opportunities arise. An institution s liquidity may be pressured if, for example, its credit rating is downgraded, it experiences a sudden and unexpected substantial cash outflow, or some other event causes counterparties to avoid exposure to the institution. An institution is also exposed to liquidity risk if markets on which it depends are subject to loss of liquidity. The objective of effective liquidity management is to ensure that the Corporation remains sufficiently liquid to meet all of its financial obligations, finance expected future growth and maintain a reasonable safety margin for cash commitments under both normal operating conditions and under unpredictable circumstances of industry or market stress.
Liquidity is managed at the level of the holding companies that own the banking and non-banking subsidiaries. Also, it is managed at the level of the banking and non-banking subsidiaries.
As of June 30, 2008, there have been no significant or unusual changes in the Corporation s funding activities and strategy from those described in the MD\&A included in Popular, Inc. s 2007 Annual Report for the year ended December 31, 2007, other than changes in short-term borrowings and deposits in the normal course of business, repayment of $\$ 500$ million in medium-term notes upon their maturity in April 2008, and the $\$ 400$ million preferred stock offering mentioned in the Overview section of this MD\&A. Also, there have been no significant changes in the Corporation s aggregate contractual obligations since the end of 2007.
Refer to Note 13 to the consolidated financial statements for the composition of the Corporation s borrowings as of June 30, 2008. Also, refer to Note 16 to the consolidated financial statements for the Corporation $s$ involvement in certain commitments as of June 30, 2008.

## Liquidity, Funding and Capital Resources

Sources of liquidity include both those available to the banking affiliates and to a lesser extent, those expected to be available with third party providers. The former include access to stable base of core deposits and other sources of credit. The latter include unsecured and secured credit lines and anticipated debt offerings in the capital markets. In addition to these, asset sales could be a source of liquidity to the Corporation. Even if some of these alternatives may not be available temporarily, it is expected that in the normal course of business, our funding sources are adequate. The following sections provide further information on the Corporation s major funding activities and needs, as well as the risks involved in these activities. A more detailed description of the Corporation s borrowings, including its terms, is included in Note 13 to the consolidated financial statements. Also, the consolidated statements of cash flows in the accompanying consolidated financial statements provide information on the Corporation s cash inflows and outflows.

## Banking Subsidiaries

Primary sources of funding for the Corporation s banking subsidiaries (BPPR, BPNA and BP,N.A., or the banking subsidiaries ) include retail and commercial deposits, purchased funds, institutional borrowings, and to a lesser extent, loan sales. The principal uses of funds for the banking subsidiaries include loan and investment portfolio growth, repayment of obligations as they become due, dividend payments to the holding company, and operational needs. In addition, the Corporation s banking subsidiaries maintain borrowing facilities with the Federal Home Loan Banks ( FHLB ) and at the discount window of the Federal Reserve Bank of New York ( FED ), and have a considerable amount of collateral that can be used to raise funds under these facilities. Borrowings from the FHLB or the FED discount window require the Corporation to post securities or whole loans as collateral. The banking subsidiaries must maintain their FHLB memberships to continue accessing this source of funding.

## Table of Contents

The Corporation s ability to compete successfully in the marketplace for deposits depends on various factors, including pricing, service, convenience and financial stability as reflected by operating results and credit ratings (by nationally recognized credit rating agencies). Although a downgrade in the credit rating of the Corporation may impact its ability to raise deposits or the rate it is required to pay on such deposits, management does not believe that the impact should be material. Deposits at all of the Corporation s banking subsidiaries are federally insured and this is expected to mitigate the effect of a downgrade in credit ratings.
The Corporation s banking subsidiaries have the ability to borrow funds from the FHLB at competitive prices. As of June 30, 2008, the banking subsidiaries had short-term and long-term credit facilities authorized with the FHLB aggregating $\$ 2.2$ billion based on assets pledged with the FHLB at that date, compared with $\$ 2.6$ billion as of December 31, 2007. Outstanding borrowings under these credit facilities totaled $\$ 1.7$ billion as of June 30, 2008, compared with $\$ 1.7$ billion as of December 31, 2007. Such advances are collateralized by securities and mortgage loans, do not have restrictive covenants and in the most part do not have any callable features. Refer to Note 13 to the consolidated financial statements for additional information.
As of June 30, 2008, the banking subsidiaries had a borrowing capacity at the FED discount window of approximately $\$ 3.4$ billion, of which $\$ 2.8$ billion remained unused as of that date. This compares to a borrowing capacity at the FED discount window of $\$ 3.0$ billion as of December 31, 2007 which was unused at that date. This facility is a collateralized source of credit that is highly reliable even under difficult market conditions. The amount available under this line is dependent upon the balance of loans and securities pledged as collateral.

## Bank Holding Companies

The principal sources of funding for the holding companies have included dividends received from its banking and non-banking subsidiaries and proceeds from the issuance of medium-term notes, commercial paper, junior subordinated debentures and equity. Banking laws place certain restrictions on the amount of dividends a bank may make to its parent company. Such restrictions have not had, and are not expected to have, any material effect on the Corporation s ability to meet its cash obligations. The principal uses of these funds include the repayment of maturing debt, dividend payments to shareholders and subsidiary funding through capital or debt.
The Corporation s bank holding companies ( BHCs , Popular, Inc., Popular North America and Popular International Bank, Inc.) have borrowed in the money markets and the corporate debt market primarily to finance their non-banking subsidiaries.
The BHCs have additional sources of liquidity available, in the form of credit facilities available from affiliate banking subsidiaries and third party providers, as well as dividends that can be paid by the subsidiaries and assets that could be sold or financed. Other potential sources of funding include the issuance of shares of common or preferred stock, or hybrid securities.
During the six-months ended June 30, 2008, the Corporation s holding companies did not issue any debt or other securities under a registration statement filed with the SEC, except for the aforementioned $\$ 400$ million in preferred stock.
The principal source of income for the PIHC consists of dividends from BPPR. As members subject to the regulations of the Federal Reserve System, BPPR and BPNA must obtain the approval of the Federal Reserve Board for any dividend if the total of all dividends declared by each entity during the calendar year would exceed the total of its net income for that year, as defined by the Federal Reserve Board, combined with its retained net income for the preceding two years, less any required transfers to surplus or to a fund for the retirement of any preferred stock. The payment of dividends by BPPR may also be affected by other regulatory requirements and policies, such as the maintenance of certain minimum capital levels. As of June 30, 2008, BPPR could have declared a dividend of approximately $\$ 110$ million without the approval of the Federal Reserve Board. As of June 30, 2008, BPNA was required to obtain the approval of the Federal Reserve Board to declare a dividend. The Corporation has never received dividend payments from its U.S. subsidiaries. Refer to Popular, Inc. s Form 10-K for the year ended December 31, 2007 for further information on dividend restrictions imposed by regulatory requirements and policies on the payment of dividends by BPPR, BPNA and BP, N.A.

## Table of Contents

## Risks to Liquidity

The importance of the Puerto Rico market for the Corporation is an additional risk factor that could affect its financing activities. In the case of an extended economic slowdown in Puerto Rico, the credit quality of the Corporation could be affected and, as a result of higher credit costs, profitability may decrease. The substantial integration of Puerto Rico with the U.S. economy may mitigate the impact of a recession in Puerto Rico, but a U.S. recession, concurrently with a slowdown in Puerto Rico, may make a recovery in the local economic cycle more challenging.
Factors that the Corporation does not control, such as the economic outlook of its principal markets and regulatory changes, could affect its ability to obtain funding. In order to prepare for the possibility of such a scenario, management has adopted contingency plans for raising financing under stress scenarios when important sources of funds that are usually fully available, are temporarily unavailable. These plans call for using alternate funding mechanisms such as the pledging or securitization of certain asset classes and accessing secured credit lines and loan facilities put in place with the FHLB, leading commercial banks and the FED. The Corporation has a substantial amount of assets available for raising funds through these channels and is confident that it has adequate alternatives to rely on under a scenario where some primary funding sources are temporarily unavailable.
The BHCs are considering alternate sources for raising liquidity, including sales of some or all of their operations in the United States mainland or the assets of those operations. Given that conditions in the financial markets remain difficult, these alternative sources may not be available to the BHCs, and even if available the costs of raising liquidity have remained significantly higher than experienced in recent years. Among the criteria considered in pursuing alternate sources of liquidity are speed of execution and cost. To the extent that the BHC s are required to sell operations or assets to fulfill liquidity needs, losses on their disposition may be incurred, which may be significant. Maintaining adequate credit ratings on Popular s debt obligations is an important factor for liquidity, because the credit ratings influence the Corporation s ability to borrow, the cost at which it can raise financing and access to funding sources. The credit ratings are based on the financial strength, credit quality and concentrations in the loan portfolio, the level and volatility of earnings, capital adequacy, the quality of management, the liquidity of the balance sheet, the availability of a significant base of core retail and commercial deposits, and the Corporation sability to access a broad array of wholesale funding sources, among other factors. Changes in the credit rating of the Corporation or any of its subsidiaries to a level below investment grade may affect the Corporation s ability to raise funds in the capital markets. The Corporation s counterparties are sensitive to the risk of a rating downgrade. In the event of a downgrade, it may be expected that the cost of borrowing funds in the institutional market would increase. In addition, the ability of the Corporation to raise new funds or renew maturing debt may be more difficult.
Credit ratings are an important factor in accessing the credit markets. Even though the Corporation is currently several notches above the investment-grade threshold with each of the rating agencies, the possibility of ratings downgrades can affect our ability to raise unsecured financing at competitive rates.
The Corporation and BPPR s debt ratings and outlook as of June 30, 2008 were as follows:

|  | Popular, Inc. <br> Short-term <br> Lobs-term <br> debt |  |  | Outlook | Short-term <br> debt |
| :--- | :---: | :---: | :---: | :---: | :---: |
| LebPR | debt |  |  |  |  |
| Fitch Ratings | F-2 | A- | Negative | F-1 | A- |
| Moody s | P-2 | A3 | Negative | P-1 | A2 |
| S\&P | A-2 | BBB+ | Stable | A-2 | A- |

Refer to the Corporation s Form 10-K for more detailed information on the ratings agencies perspective on Popular s outlook. Ratings and outlook have remained similar to those reported as of December 31, 2007, except for Moody s that changed their outlook to negative in May 2008. The ratings above are subject to revisions or withdrawal at any time by the assigning rating agency. Each rating should be evaluated independently of any other

## Table of Contents

rating.
Some of the Corporation s borrowings and deposits are subject to rating triggers , contractual provisions that accelerate the maturity of the underlying obligations in the case of a change in rating. Therefore, the need for the Corporation to raise funding in the marketplace could increase more than usual in the case of a rating downgrade. The amount of obligations subject to rating triggers that could accelerate the maturity of the underlying obligations was $\$ 39$ million as of June 30, 2008.
In the course of borrowing from institutional lenders, the Corporation has entered into contractual agreements to maintain certain levels of debt, capital and asset quality, among other financial covenants. If the Corporation were to fail to comply with those agreements, it may result in an event of default. Such failure may accelerate the repayment of the related obligations or restrict additional borrowings under such facilities. An event of default could also affect the ability of the Corporation to raise new funds or renew maturing borrowings. As of June 30, 2008, the Corporation had $\$ 0.1$ billion in outstanding obligations subject to covenants, including those which are subject to rating triggers. As of June 30, 2008, the Corporation was in compliance with debt covenants in all credit facilities with outstanding balances.

## Item 4. Controls and Procedures

## Disclosure Controls and Procedures

The Corporation s management, with the participation of the Corporation s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Corporation s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, the Corporation s Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Corporation s disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Corporation in the reports that it files or submits under the Exchange Act and such information is accumulated and communicated to management, as appropriate, to allow timely decisions regarding required disclosures.

## Internal Control Over Financial Reporting

There have been no changes in the Corporation s internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended on June 30, 2008 that have materially affected, or are reasonably likely to materially affect, the Corporation s internal control over financial reporting.

## Part II Other Information

Item 1. Legal Proceedings
The Corporation and its subsidiaries are defendants in various lawsuits arising in the ordinary course of business. Management believes, based on the opinion of legal counsel, that the aggregate liabilities, if any, arising from such actions will not have a material adverse effect on the financial position and results of operations of the Corporation.

## Item 1A. Risk Factors

For a detailed discussion of certain risk factors that could affect the Corporation s results for future periods see Item 1A, Risk Factors, in Popular, Inc. s 2007 Annual Report on Form 10-K.
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Issuer Purchases of Equity Securities
In April 2004, the Corporation s shareholders adopted the Popular, Inc. 2004 Omnibus Incentive Plan. The maximum number of shares of common stock issuable under this Plan is $10,000,000$.

## Table of Contents

The following table sets forth the details of purchases of common stock during the quarter ended June 30, 2008 under the 2004 Omnibus Incentive Plan.
Not in thousands

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares <br> Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (a) |
| :---: | :---: | :---: | :---: | :---: |
| April 1 April 30 |  |  |  | 8,566,298 |
| May 1 May 31 | 41,926 | \$ 11.42 | 41,926 | 8,524,372 |
| June 1 June 30 |  |  |  | 8,525,349 |
| Total June 30, 2008 | 41,926 | \$ 11.42 | 41,926 | 8,525,349 |

(a) Includes shares forfeited.
Item 4. Submission of Matters to a Vote of Security Holders The Annual Shareholders Meeting of Popular, Inc. was held on April 25, 2008. A quorum was obtained with $248,222,084$ shares represented in person or by proxy, which represented approximately $88.46 \%$ of all votes eligible to be cast at the meeting. Three Directors of the Corporation, María Luisa Ferré, Frederic V. Salerno, and William Teuber Jr., were elected for a three-year term. The following directors were not up for reelection and continued to hold office after the meeting: Juan J. Bermúdez, Richard L. Carrión, Francisco M. Rexach Jr., Michael J. Masin, Manuel Morales Jr., and José R. Vizcarrondo. The ratification of PricewaterhouseCoopers LLP as the Corporation s independent registered public accounting firm for 2008 was also approved at the Annual Meeting. The result of the voting on each of the proposals is set forth below: Proposal 1: Election of three (3) Class 3 Directors for a three-year term:

| Nominees | Votes For | Withheld |
| :--- | ---: | ---: |
| María Luisa Ferré | $232,630,564$ | $15,591,521$ |
| Frederic V. Salerno | $236,980,346$ | $11,241,739$ |
| William Teuber Jr. | $241,767,768$ | $6,454,317$ |

Proposal 2: Ratification of the appointment of PricewaterhouseCoopers LLP as the Corporation s independent registered public accounting firm for 2008:

In favor:
Against:
5,501,134
Abstain:
1,636,127

## Item 6. Exhibits

Exhibit No.
Exhibit Description
12.1 Computation of the ratios of earnings to fixed charges and preferred stock dividends.
31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2

Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## Table of Contents

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

## POPULAR, INC. <br> (Registrant)

Date: August 11, 2008

Date: August 11, 2008

By: /s/ Jorge A. Junquera<br>Jorge A. Junquera<br>Senior Executive Vice President \& Chief Financial Officer

By: /s/ Ileana González Quevedo
Ileana González Quevedo
Senior Vice President \& Corporate
Comptroller

