ORIENTAL FINANCIAL GROUP INC
Form 10-Q
August 03, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

or

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

For the transition period from ______________ to ______________

Commission File Number 001-12647

Oriental Financial Group Inc.

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

Principal Executive Offices:

997 San Roberto Street

Oriental Center 10th Floor

Professional Offices Park

San Juan, Puerto Rico 00926

Telephone Number: (787) 771-6800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated Filer ¨ Smaller Reporting Company ¨
(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). Yes ¨ No x

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

40,738,762 common shares ($1.00 par value per share) outstanding as of July 31, 2012

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FORWARD-LOOKING STATEMENTS

The information included in this quarterly report on 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 financial condition, results of operations, plans, objectives, future performance and business of Oriental Financial Group Inc. (the “Group”), including, but not limited to, statements with respect to the adequacy of the allowance for loan losses, delinquency trends, 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 Group’s financial condition and results of operations. All statements contained herein that are not clearly historical in nature are forward-looking, and the words “anticipate,” “believe,” “continues,” “expect,” “estimate,” “intend,” “project” and similar expre and future or conditional verbs such as “will,” “would,” “should,” “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 by their nature are beyond the Group’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 and employment levels, 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;
- a credit default by the U.S. or Puerto Rico governments or a downgrade in the credit ratings of the U.S. or Puerto Rico governments;
- changes in federal bank regulatory and supervisory policies, including required levels of capital;
- the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) on the Group’s businesses, business practices and cost of operations;
- the relative strength or weakness of the consumer and commercial credit sectors and of the real estate market in Puerto Rico;
- the performance of the stock and bond markets;
- competition in the financial services industry;
- additional Federal Deposit Insurance Corporation (“FDIC”) assessments;
- possible legislative, tax or regulatory changes;

- the receipt and timing of regulatory approvals required to consummate the acquisition of the Puerto Rico operations of Banco Bilbao Vizcaya Argentaria, S.A. ("BBVA"); and
- difficulties in integrating BBVA's Puerto Rico operations into the Group's operations.

Other possible events or factors that could cause results or performance to differ materially from those expressed in these forward-looking statements include the following: negative economic conditions that adversely affect the general economy, housing prices, the job market, consumer confidence and spending habits which may affect, among other things, the level of non-performing assets, charge-offs and provision expense; changes in interest rates and market liquidity which may reduce interest margins, impact funding sources and affect the ability to originate and distribute financial products in the primary and secondary markets; adverse movements and volatility in debt and equity capital markets; changes in market rates and prices which may adversely impact the value of financial assets and liabilities; liabilities resulting from litigation and regulatory investigations; changes in accounting standards, rules and interpretations; increased competition; the Group's ability to grow its core businesses; decisions to downsize, sell or close units or otherwise change the Group's business mix; and management's ability to identify and manage these and other risks.

All forward-looking statements included in this quarterly report on Form 10-Q are based upon information available to the Group as of the date of this report, and other than as required by law, including the requirements of applicable securities laws, the Group assumes 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.

ORIENTAL FINANCIAL GROUP INC.

UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

JUNE 30, 2012 AND DECEMBER 31, 2011

		June 30, 2012		December 31, 2011
		(In thousands, except share data)		
ASSETS				
Cash and cash equivalents				
Cash and due from banks	$	459,917	$	587,624
Money market investments		4,662		3,863
Total cash and cash equivalents		**464,579**		**591,487**
Securities purchased under agreements to resell		**225,000**		**-**
Investments:				
Trading securities, at fair value, with amortized cost of $211 (December 31, 2011 - $176)		214		180
Investment securities available-for-sale, at fair value, with amortized cost of $2,536,772 (December 31, 2011 - $2,873,682)		2,612,839		2,959,912
Investment securities held-to-maturity, at amortized cost, with fair value of $925,266 (December 31, 2011 - $904,556)		895,500		884,026
Federal Home Loan Bank (FHLB) stock, at cost		22,868		23,779
Other investments		69		73
Total investments		**3,531,490**		**3,867,970**
Loans:				
Mortgage loans held-for-sale, at lower of cost or fair value		34,718		26,939
Loans not covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of $37,402 (December 31, 2011 - $37,010)		1,137,918		1,142,978
Loans covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of $58,628 (December 31, 2011 - $37,256)		447,720		496,276
Total loans, net		**1,620,356**		**1,666,193**
FDIC shared-loss indemnification asset		359,767		392,367
Foreclosed real estate covered under shared-loss agreements with the FDIC		13,910		13,867
Foreclosed real estate not covered under shared-loss agreements with the FDIC		17,721		13,812
Accrued interest receivable		17,258		20,182
Deferred tax asset, net		35,887		32,023
Premises and equipment, net		20,090		21,520
Servicing assets		10,776		10,454
Derivative assets		11,367		9,317

Other assets		47,447		54,483
Total assets	$	**6,375,648**	$	**6,693,675**
LIABILITIES AND STOCKHOLDERS' EQUITY				
Deposits:				
Demand deposits	$	1,061,849	$	1,043,031
Savings accounts		230,920		230,672
Certificates of deposit		930,173		1,161,482
Total deposits		**2,222,942**		**2,435,185**
Borrowings:				
Securities sold under agreements to repurchase		3,053,865		3,056,238
Advances from FHLB		286,653		281,753
FDIC-guaranteed term notes		-		105,834
Subordinated capital notes		36,083		36,083
Total borrowings		**3,376,601**		**3,479,908**
Derivative liabilities		56,217		47,425
Accrued expenses and other liabilities		27,686		35,602
Total liabilities		**5,683,446**		**5,998,120**
Stockholders' equity:				
Preferred stock, $1 par value; 10,000,000 shares authorized; 1,340,000 shares of Series A and 1,380,000 shares of Series B issued and outstanding, $25 liquidation value		68,000		68,000
Common stock, $1 par value; 100,000,000 shares authorized; 47,841,611 shares issued; 40,730,831 shares outstanding (December 31, 2011 - 47,808,657; 41,244,533)		47,842		47,809
Additional paid-in capital		499,852		499,096
Legal surplus		52,668		50,178
Retained earnings		83,982		68,149
Treasury stock, at cost, 7,110,780 shares (December 31, 2011 - 6,564,124 shares)		(81,403)		(74,808)
Accumulated other comprehensive income, net of tax of -$1,411 (December 31, 2011 - $1,848)		21,261		37,131
Total stockholders' equity		**692,202**		**695,555**
Total liabilities and stockholders' equity	$	**6,375,648**	$	**6,693,675**

See notes to unaudited consolidated financial statements

ORIENTAL FINANCIAL GROUP INC.

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2012 AND 2011

	Quarter Ended June 30,				Six-Month Period Ended June 30,			
	2012		2011		2012		2011	
	(In thousands, except per share data)							
Interest income:								
Loans not covered under shared-loss agreements with the FDIC	$	17,223	$	15,969	$	35,345	$	33,934
Loans covered under shared-loss agreements with the FDIC		20,342		13,060		41,884		27,285
Total interest income from loans		**37,565**		**29,029**		**77,229**		**61,219**
Mortgage-backed securities		22,011		51,021		50,337		94,759
Investment securities and other		1,212		2,152		3,142		4,258
Total interest income		**60,788**		**82,202**		**130,708**		**160,236**
Interest expense:								
Deposits		7,964		11,546		17,210		23,829
Securities sold under agreements to repurchase		16,586		23,512		34,156		47,671
Advances from FHLB and other borrowings		2,841		3,002		5,845		5,994
FDIC-guaranteed term notes		-		1,021		909		2,042
Subordinated capital notes		321		308		649		611
Total interest expense		**27,712**		**39,389**		**58,769**		**80,147**
Net interest income		**33,076**		**42,813**		**71,939**		**80,089**
Provision for non-covered loan and lease losses		3,800		3,800		6,800		7,600
Provision for covered loan and lease losses, net		1,467		-		8,624		549
Total provision for loan and lease losses		**5,267**		**3,800**		**15,424**		**8,149**
Net interest income after provision for loan and lease losses		**27,809**		**39,013**		**56,515**		**71,940**
Non-interest income:								
Wealth management revenues		5,903		4,575		11,791		9,257
Banking service revenues		3,407		3,234		6,693		6,958
Mortgage banking activities		2,436		2,435		4,938		4,258
Total banking and wealth management revenues		**11,746**		**10,244**		**23,422**		**20,473**
Net (amortization) accretion of FDIC shared-loss indemnification asset		(5,583)		1,020		(10,410)		2,231
Net gain (loss) on:								
Sale of securities		11,979		9,132		19,338		9,130
Derivatives		(107)		(3,704)		(108)		(7,660)
Foreclosed real estate		(886)		(3)		(1,284)		(135)

Other	63	70	(777)	125
Total non-interest income, net	**17,212**	**16,759**	**30,181**	**24,164**
Non-interest expense:				
Compensation and employee benefits	11,184	11,230	21,550	22,918
Professional and service fees	5,144	5,750	10,442	11,197
Occupancy and equipment	4,270	4,214	8,455	8,619
Insurance	1,442	1,646	3,262	3,632
Electronic banking charges	1,609	1,155	3,166	2,610
Taxes, other than payroll and income taxes	(107)	858	1,067	2,237
Loan servicing and clearing expenses	955	1,076	1,923	2,097
Foreclosure, repossession and other real estate expenses	1,198	761	2,153	1,484
Advertising, business promotion, and strategic initiatives	1,564	1,508	2,412	2,700
Communication	415	425	827	822
Director and investor relations	342	339	651	625
Printing, postage, stationary and supplies	322	362	629	644
Other	668	1,372	1,555	1,890
Total non-interest expense	**29,006**	**30,696**	**58,092**	**61,475**
Income before income taxes	**16,015**	**25,076**	**28,604**	**34,629**
Income tax expense (benefit)	1,057	(1,391)	2,994	5,081
Net income	**14,958**	**26,467**	**25,610**	**29,548**
Less: Dividends on preferred stock	(1,200)	(1,200)	(2,401)	(2,401)
Income available to common shareholders	**$ 13,758**	**$ 25,267**	**$ 23,209**	**$ 27,147**
Income per common share:				
Basic	**$ 0.34**	**$ 0.56**	$ **0.57**	**$ 0.60**
Diluted	**$ 0.34**	**$ 0.56**	$ **0.57**	**$ 0.59**
Average common shares outstanding and equivalents	**40,808**	**45,135**	**40,986**	**45,656**
Cash dividends per share of common stock	**$ 0.06**	**$ 0.05**	$ **0.12**	**$ 0.10**

See notes to unaudited consolidated financial statements

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ORIENTAL FINANCIAL GROUP INC.

UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2012 AND 2011

	Quarter Ended June 30, 2012	Quarter Ended June 30, 2011	Six-Month Period Ended June 30, 2012	Six-Month Period Ended June 30, 2011
	(In thousands)		(In thousands)	
Net income	**$ 14,958**	**$ 26,467**	**$ 25,610**	**$ 29,548**
Other comprehensive income (loss) before tax:				
Unrealized gain on securities available-for-sale	7,059	35,365	9,000	21,627
Realized gain on investment securities included in net income	(11,979)	(9,132)	(19,338)	(9,130)
Unrealized loss on cash flow hedges	(6,791)	(21,041)	(8,792)	(13,918)
Other comprehensive income (loss) before taxes	**(11,711)**	**5,192**	**(19,130)**	**(1,421)**
Income tax effect	2,875	(637)	3,260	(692)
Other comprehensive income (loss) after taxes	**(8,836)**	**4,555**	**(15,870)**	**(2,113)**
Comprehensive income	**$ 6,122**	**$ 31,022**	**$ 9,740**	**$ 27,435**

See notes to unaudited consolidated financial statements

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ORIENTAL FINANCIAL GROUP INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2012 AND 2011

	Six-Month Period Ended June 30,	
	2012	2011
	(In thousands)	
Preferred stock:		
Balance at beginning and end of period	**$ 68,000**	**$ 68,000**
Common stock:		
Balance at beginning of period	47,809	47,808
Exercised stock options	33	-
Balance at end of period	**47,842**	**47,808**
Additional paid-in capital:		
Balance at beginning of period	499,096	498,435
Stock-based compensation expense	787	682
Exercised stock options	361	-
Lapsed restricted stock units	(392)	(561)
Balance at end of period	**499,852**	**498,556**
Legal surplus:		
Balance at beginning of period	50,178	46,331
Transfer from retained earnings	2,490	3,083
Balance at end of period	**52,668**	**49,414**
Retained earnings:		
Balance at beginning of period	68,149	51,502
Net income	25,610	29,548
Cash dividends declared on common stock	(4,886)	(4,475)
Cash dividends declared on preferred stock	(2,401)	(2,401)
Transfer to legal surplus	(2,490)	(3,083)
Balance at end of period	**83,982**	**71,091**
Treasury stock:		
Balance at beginning of period	(74,808)	(16,732)
Stock purchased	(7,022)	(29,242)
Lapsed restricted stock units	392	561
Stock used to match defined contribution plan	35	27
Balance at end of period	**(81,403)**	**(45,386)**
Accumulated other comprehensive income, net of tax:		
Balance at beginning of period	37,131	36,987
Other comprehensive loss, net of tax	(15,870)	(2,113)
Balance at end of period	**21,261**	**34,874**
Total stockholders' equity	**$ 692,202**	**$ 724,357**

See notes to unaudited consolidated financial statements

ORIENTAL FINANCIAL GROUP INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2012 AND 2011

	Six-Month Period Ended June 30,	
	2012	2011
	(In thousands)	
Cash flows from operating activities:		
Net income	$ **25,610**	$ **29,548**
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of deferred loan origination fees, net of costs	297	(27)
Amortization of investment securities premiums, net of accretion of discounts	25,558	6,186
Amortization of core deposit intangible	75	71
Net amortization (accretion) of FDIC shared-loss indemnification asset	10,410	(2,231)
Depreciation and amortization of premises and equipment	2,373	2,748
Deferred income taxes, net	(420)	(2,753)
Provision for covered and non-covered loan and lease losses, net	15,424	8,149
Stock-based compensation	787	682
(Gain) loss on:		
Sale of securities	(19,338)	(9,130)
Sale of mortgage loans held for sale	(2,898)	(2,441)
Derivatives	108	7,660
Foreclosed real estate	1,284	135
Sale of premises and equipment	(86)	38
Originations and purchases of loans held-for-sale	(93,940)	(106,955)
Proceeds from sale of loans held-for-sale	49,388	36,608
Net (increase) decrease in:		
Trading securities	(34)	466
Accrued interest receivable	2,924	2,286
Servicing assets	(322)	(145)
Other assets	6,872	773
Net increase (decrease) in:		
Accrued interest on deposits and borrowings	(4,498)	(707)
Accrued expenses and other liabilities	(13,167)	(22,062)
Net cash provided by (used in) operating activities	**6,407**	**(51,101)**
Cash flows from investing activities:		
Purchases of:		
Investment securities available-for-sale	(558,201)	(492,533)
Investment securities held-to-maturity	(119,025)	(209,112)

FHLB stock	-	(1,283)
Equity options	-	(370)
Maturities and redemptions of:		
Investment securities available-for-sale	378,144	446,958
Investment securities held-to-maturity	102,251	33,412
FHLB stock	911	-
Proceeds from sales of:		
Investment securities available-for-sale	553,602	252,836
Foreclosed real estate	4,639	5,806
Other repossessed assets	1,941	2,842
Premises and equipment	368	11
Origination and purchase of loans, excluding loans held-for-sale	(112,974)	(87,675)
Principal repayment of loans, including covered loans	128,340	133,000
Reimbursements from the FDIC on shared-loss agreements	39,729	39,870
Additions to premises and equipment	(1,225)	(2,474)
Net change in securities purchased under agreements to resell	(225,000)	-
Net cash provided by investing activities	**193,500**	**121,288**

See notes to unaudited consolidated financial statements

ORIENTAL FINANCIAL GROUP INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)

FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2012 AND 2011

	Six-Month Period Ended June 30,			
	2012		2011	
	(In thousands)			
Cash flows from financing activities:				
Net increase (decrease) in:				
Deposits		(212,846)		(215,234)
Securities sold under agreements to repurchase		-		2,600
FHLB advances		5,070		-
FDIC-guaranteed term notes		(105,000)		-
Exercise of stock options		394		-
Purchase of treasury stock		(7,022)		(29,242)
Termination of derivative instruments		(124)		10,648
Dividends paid on preferred stock		(2,401)		(2,401)
Dividends paid on common stock		(4,886)		(4,475)
Net cash used in financing activities		**(326,815)**		**(238,104)**
Net change in cash and cash equivalents		**(126,908)**		**(167,917)**
Cash and cash equivalents at beginning of period		591,487		448,946
Cash and cash equivalents at end of period	**$**	**464,579**	**$**	**281,029**
Supplemental Cash Flow Disclosure and Schedule of Non-cash Activities:				
Interest paid	$	63,266	$	80,854
Income taxes paid	$	8,031	$	3,848
Mortgage loans securitized into mortgage-backed securities	$	37,730	$	71,007
Transfer from loans to foreclosed real estate	$	11,723	$	10,464

See notes to unaudited consolidated financial statements

ORIENTAL FINANCIAL GROUP INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

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

The unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). All significant intercompany balances 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 information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to SEC rules and regulations. Management believes that the disclosures made are adequate to make the information presented not misleading. The results of operations and cash flows for the periods ended June 30, 2012 and 2011 are not necessarily indicative of the results to be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2011, included in the Group’s 2011 annual report on Form 10-K.

Nature of Operations

The Group is a publicly-owned financial holding company incorporated under the laws of the Commonwealth of Puerto Rico. It has four direct subsidiaries, Oriental Bank and Trust (the “Bank”), Oriental Financial Services Corp. (“Oriental Financial Services”), Oriental Insurance, Inc. (“Oriental Insurance”) and Caribbean Pension Consultants, Inc., which is located in Boca Raton, Florida. The Group also has a special purpose entity, Oriental Financial (PR) Statutory Trust II (the “Statutory Trust II”). Through these subsidiaries and their respective divisions, the Group provides a wide range of banking and wealth management services such as mortgage, commercial and consumer lending, leasing, financial planning, insurance sales, money management and investment banking and brokerage services, as well as corporate and individual trust services.

The main offices of the Group and its subsidiaries are located in San Juan, Puerto Rico. The Group is subject to supervision and regulation by the Federal Reserve Board under the U.S. Bank Holding Company Act of 1956, as amended, and the Dodd-Frank Act.

The Bank operates through 28 financial centers located throughout Puerto Rico and is subject to the supervision, examination and regulation of the Office of the Commissioner of Financial Institutions of Puerto Rico (the “OCFI”) and the Federal Deposit Insurance Corporation (the “FDIC”). The Bank offers banking services such as commercial and consumer lending, leasing, savings and time deposit products, financial planning, and corporate and individual trust services, and capitalizes on its commercial banking network to provide mortgage lending products to its clients. Oriental International Bank Inc. (“OIB”), a wholly-owned subsidiary of the Bank, is an international banking entity pursuant to the International Banking Center Regulatory Act of Puerto Rico, as amended. OIB offers the Bank certain Puerto Rico tax advantages. OIB’s activities are limited under Puerto Rico law to persons and assets/liabilities located outside of Puerto Rico.

Oriental Financial Services is a securities broker-dealer and is subject to the supervision, examination and regulation of the Financial Industry Regulatory Authority (the “FINRA”), the SEC, and the OCFI. Oriental Insurance is an insurance agency and is subject to the supervision, examination and regulation of the Office of the Commissioner of Insurance of Puerto Rico.

The Group’s mortgage banking activities are conducted through a division of the Bank. The mortgage banking activities include the origination of mortgage loans for the Bank’s own portfolio, and the sale of loans directly in the secondary market or the securitization of conforming loans into mortgage-backed securities. The Bank originates Federal Housing Administration (“FHA”) insured and Veterans Administration (“VA”) guaranteed mortgages that are primarily securitized for issuance of Government National Mortgage Association (“GNMA”) mortgage-backed securities which can be resold to individual or institutional investors in the secondary market. Conventional loans that meet the underwriting requirements for sale or exchange under certain Federal National Mortgage Association (the “FNMA”) or Federal Home Loan Mortgage Corporation (the “FHLMC”) programs are referred to as conforming mortgage loans and are also securitized for issuance of FNMA or FHLMC mortgage-backed securities. The Bank is an approved seller of FNMA, as well as FHLMC, mortgage loans for issuance of FNMA and FHLMC mortgage-backed securities. The Bank is also an approved issuer of GNMA mortgage-backed securities. The Bank is the master servicer of the GNMA, FNMA and FHLMC pools that it issues and of its mortgage loan portfolio, and has a subservicing arrangement with a third party.

ORIENTAL FINANCIAL GROUP INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Effective April 30, 2010, the Bank assumed all of the retail deposits and other liabilities and acquired certain assets and substantially all of the operations of Eurobank from the FDIC, as receiver for Eurobank, pursuant to the terms of a purchase and assumption agreement entered into by the Bank and the FDIC on April 30, 2010. This transaction is referred to as the “FDIC-assisted acquisition.”

On June 28, 2012, the Group entered into a definitive Acquisition Agreement (the “Acquisition Agreement”) with Banco Bilbao Vizcaya Argentaria, S.A. (“BBVA”), pursuant to which BBVA agreed to sell to the Group, and the Group agreed to purchase from BBVA, all of the outstanding common stock of each of BBVA PR Holding Corporation (the sole shareholder of Banco Bilbao Vizcaya Argentaria Puerto Rico, a Puerto Rico chartered commercial bank (“BBVA Puerto Rico”), and BBVA Seguros, Inc., a subsidiary offering insurance services) and BBVA Securities of Puerto Rico, Inc., a registered broker-dealer. This transaction is referred to as the “BBVA-PR Acquisition.”

The Group will acquire all of the outstanding common stock of each of BBVA PR Holding Corporation and BBVA Securities of Puerto Rico, Inc. with total assets amounting to $5.0 billion, including $3.7 billion in gross loans, and $3.4 billion in deposits for an aggregate purchase price of $500 million. Immediately following the closing of the BBVA-PR Acquisition, the Group will merge BBVA Puerto Rico with and into the Bank, with the Bank continuing as the surviving entity. The unaudited consolidated financial statements do not contemplate the effect of the BBVA-PR Acquisition as the transaction has not been consummated at June 30, 2012.

Closing of the transaction is targeted for before year end 2012. Consummation of the BBVA-PR Acquisition is subject to certain customary conditions, including the receipt of required regulatory approvals without the imposition of a materially burdensome regulatory condition, as described in the Acquisition Agreement.

In connection with the BBVA-PR Acquisition, on July 3, 2012, the Group completed its sale to various institutional purchasers of $84 million of its 8.750% Non-Cumulative Convertible Perpetual Preferred Stock, Series C (the “Convertible Preferred Stock”), with a conversion price of $11.77, through a private placement, pursuant to a Subscription Agreement dated June 28, 2012, between the Group and each of the purchasers. In addition to the sale of Convertible Preferred Stock, prior to the closing, the Group agreed in the Acquisition Agreement to use its reasonable best efforts to raise at least an additional $66 million through the sale of additional equity (the “Buyer Capital Raise”). BBVA agreed to use its reasonable best efforts to provide information requested by the Group, and otherwise to cooperate, in connection with the Buyer Capital Raise. The Group intends to use its own excess capital to fund the balance of the purchase price.

Under the Acquisition Agreement, we may be subject to a reverse break-up fee of $25 million if the closing of the transaction does not occur before one year after execution of the Acquisition Agreement (or before fifteen months after execution of the Acquisition Agreement in certain circumstances), subject to certain conditions. Also, under certain conditions, if BBVA proves that is sustained losses in connection with such non-consummation in excess of the reverse break-up fee amount, BBVA may recover from us up to an additional $25 million in losses. There can be no assurance as to when or whether the acquisition will be consummated and what amounts we may be obligated to pay under the Acquisition Agreement

Significant Accounting Policies

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

Investment Securities

Securities are classified as held-to-maturity, available-for-sale or trading. Securities for which the Group has the intent and ability to hold until maturity are classified as held-to-maturity and are carried at amortized cost. Securities that might be sold prior to maturity because of interest rate changes to meet liquidity needs or to better match the repricing characteristics of funding sources are classified as available-for-sale. These securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported net of tax in other comprehensive income.

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The Group has classified certain agency-issued mortgage-backed securities as held-to-maturity. The Group has both the intent and ability to hold such securities until their maturities. Furthermore, the Group believes it will be able to recover substantially all of its recorded investment mainly because these are agency-issued mortgage-backed securities, and also because the securities cannot be contractually prepaid or otherwise settled before their stated maturity by the issuing agency, except for the principal prepayments that may occur throughout their terms based on the payment behavior of the collateral loans. Certain securities of the Group have been classified as held-to-maturity were classified as such in response to management's asset-liability management strategy. The Group believes that it can accomplish its asset-liability management goals and still maximize net interest income without having all its securities classified as available-for-sale. This designation is consistent with held-to-maturity classification requirements, specifically those stated in section 25-18 of ASC 320-10-25.

The Group classifies as trading those securities that are acquired and held principally for the purpose of selling them in the near future. These securities are carried at fair value with realized and unrealized changes in fair value included in earnings in the period in which the changes occur.

The Group's investment in the Federal Home Loan Bank ("FHLB") of New York stock, a restricted security, has no readily determinable fair value and can only be sold back to the FHLB at cost. Therefore, the carrying value represents its fair value.

Premiums and discounts are amortized to interest income over the life of the related securities using the interest method. Net realized gains or losses on sales of investment securities and unrealized loss valuation adjustments considered other than temporary, if any, on securities classified as either available-for-sale or held-to-maturity are reported separately in the statements of operations. The cost of securities sold is determined by the specific identification method.

Financial Instruments

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

The Group determines the fair value of its financial instruments based on the fair value measurement framework, which establishes a fair value hierarchy that prioritizes the inputs of valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy are described below:

Level 1 — Level 1 assets and liabilities include equity securities that are traded in an active exchange market, as well as certain U.S. Treasury and other U.S. government agency securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 — Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include (i) mortgage-backed securities for which the fair value is estimated based on valuations obtained from third-party pricing services for identical or comparable assets, (ii) debt securities with quoted prices that are traded less frequently than exchange-traded instruments and (iii) derivative contracts and financial liabilities whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models for which the determination of fair value requires significant management judgment or estimation.

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Impairment of Investment Securities

The Group conducts periodic reviews to identify and evaluate each investment in an unrealized loss position for other-than-temporary impairments. The Group separates the amount of total impairment into credit and noncredit-related amounts. The term “other-than-temporary impairment” is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Any portion of a decline in value associated with a credit loss is recognized in income, while the remaining noncredit-related component is recognized in other comprehensive income. A credit loss is determined by assessing whether the amortized cost basis of the security will be recovered by comparing it to the present value of cash flows expected to be collected from the security discounted at the rate equal to the yield used to accrete current and prospective beneficial interest for the security. The shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis is considered to be the “credit loss.”

The Group’s review for impairment generally entails, but is not limited to:

- the identification and evaluation of investments that have indications of possible other-than-temporary impairment;
- the analysis of individual investments that have fair values less than amortized cost, including consideration of the length of time the investment has been in an unrealized loss position, and the expected recovery period;
- the financial condition of the issuer or issuers;
- the creditworthiness of the obligor of the security;
- actual collateral attributes;
- any rating changes by a rating agency;
- current analysts’ evaluations;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments;
- current market conditions;
- adverse conditions specifically related to the security, industry, or a geographic area;
- the Group’s intent to sell the debt security;

- whether it is more-likely-than-not that the Group will be required to sell the debt security before its anticipated recovery; and

- other qualitative factors that could support or not an other-than-temporary impairment.

Derivative Instruments and Hedging Activities

The Group’s overall interest rate risk-management strategy incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. The Group’s goal is to manage interest rate sensitivity by modifying the repricing or maturity characteristics of certain balance sheet assets and liabilities so that the net interest margin is not, on a material basis, adversely affected by movements in interest rates. As a result of interest rate fluctuations, hedged fixed-rate assets and liabilities will appreciate or depreciate in market value. Also, for some fixed-rate assets or liabilities, the effect of this variability in earnings is expected to be substantially offset by the Group’s gains and losses on the derivative instruments that are linked to the forecasted cash flows of these hedged assets and liabilities. The Group considers its strategic use of derivatives to be a prudent method of managing interest-rate sensitivity as it reduces the exposure of earnings and the market value of its equity to undue risk posed by changes in interest rates. The effect of this unrealized appreciation or depreciation is expected to be substantially offset by the Group’s gains or losses on the derivative instruments that are linked to these hedged assets and liabilities. Another result of interest rate fluctuations is that the contractual interest income and interest expense of hedged variable-rate assets and liabilities, respectively, will increase or decrease.

Derivative instruments that are used as part of the Group’s interest rate risk-management strategy include interest rate swaps, forward-settlement swaps, futures contracts, and option contracts that have indices related to the pricing of specific balance sheet assets and liabilities. Interest rate swaps generally involve the exchange of fixed and variable-rate interest payments between two parties, based on a common notional principal amount and maturity date. Interest rate futures generally involve exchange-traded contracts to buy or sell U.S. Treasury bonds and notes in the future at specified prices. Interest rate options represent contracts that allow the holder of the option to (i) receive cash or (ii) purchase, sell, or enter into a financial instrument at a specified price within a specified period. Some purchased option contracts give the Group the right to enter into interest rate swaps and cap and floor agreements with the writer of the option. In addition, the Group enters into certain transactions that contain embedded derivatives. When the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract, it is bifurcated and carried at fair value.

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The Group also has offered its customers certificates of deposit with an option tied to the performance of the Standard & Poor's 500 stock market index. The Group purchases options from major financial entities to manage its exposure to changes in this index. Under the terms of the option agreements, the Group receives a certain percentage of the increase, if any, in the initial month-end value of the index over the average of the monthly index observations in a five-year period in exchange for a fixed premium. The changes in fair value of the option agreements used to manage the exposure in the stock market in the certificates of deposit are recorded in earnings. The embedded option in the certificates of deposit is bifurcated, and the changes in the value of that option are also recorded in earnings.

When using derivative instruments, the Group exposes itself to credit and market risk. If a counterparty fails to fulfill its performance obligations under a derivative contract due to insolvency or any other event of default, the Group's credit risk will equal the fair value gain in a derivative plus any cash or securities that may have been delivered to the counterparty as part of the transaction terms. Generally, when the fair value of a derivative contract is positive, this indicates that the counterparty owes the Group, thus creating a repayment risk for the Group. This risk is generally mitigated by requesting cash or securities from the counterparty to cover the positive fair value. When the fair value of a derivative contract is negative, the Group owes the counterparty and, therefore, assumes no credit risk other than to the extent that the cash or value of the collateral delivered as part of the transactions exceeds the fair value of the derivative. The Group minimizes the credit (or repayment) risk in derivative instruments by entering into transactions with high-quality counterparties.

The Group uses forward-settlement swaps to hedge the variability of future interest cash flows of forecasted wholesale borrowings attributable to changes in LIBOR. Once the forecasted wholesale borrowing transactions occur, the interest rate swap will effectively lock-in the Group's interest rate payments on an amount of forecasted interest expense attributable to the one-month LIBOR corresponding to the swap notional amount. By employing this strategy, the Group minimizes its exposure to volatility in LIBOR.

As part of this hedging strategy started in the first quarter of 2011, the Group formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as cash flow hedges to (i) specific assets and liabilities on the balance sheet or (ii) specific firm commitments or forecasted transactions. The Group also formally assesses (both at the hedge's inception and on an ongoing basis) whether the derivatives that are used in hedging transactions have been highly effective in offsetting changes in the fair value or cash flows of hedged items and whether those derivatives may be expected to remain highly effective in future periods. The changes in fair value of the forward-settlement swaps are recorded in accumulated other comprehensive income to the extent there is no significant ineffectiveness.

The Group discontinues hedge accounting prospectively when (i) it determines that the derivative is no longer effective in offsetting changes in the cash flows of a hedged item (including hedged items such as firm commitments or forecasted transactions); (ii) the derivative expires or is sold, terminated, or exercised; (iii) it is no longer probable that the forecasted transaction will occur; (iv) a hedged firm commitment no longer meets the definition of a firm commitment; or (v) management determines that designating the derivative as a hedging instrument is no longer appropriate or desired.

The Group's derivative activities are monitored by its Asset/Liability Management Committee which is also responsible for approving hedging strategies that are developed through its analysis of data derived from financial simulation models and other internal and industry sources. The resulting hedging strategies are then incorporated into the Group's overall interest rate risk-management.

Loans and Allowance for Loan and Lease Losses

Because of the loss protection provided by the FDIC, the risks of the loans acquired in the FDIC-assisted transaction that are covered under the FDIC shared-loss agreements are significantly different from those loans not covered under the FDIC shared-loss agreements. Accordingly, the Group presents loans subject to the shared-loss agreements as "covered loans" and loans that are not subject to the FDIC shared-loss agreements as "non-covered loans." Non-covered loans include credit card balances acquired in the FDIC-assisted acquisition.

Non-Covered Loans

Non-covered loans that management has the intent and ability to hold for the foreseeable future or until maturity or repayment are reported at their outstanding unpaid principal balances adjusted for (i) charge-offs, (ii) the allowance for non-covered loan and lease losses, (iii) unamortized discount related to mortgage servicing rights sold and (iv) any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees and costs, and premiums and discounts on loans

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purchased, are deferred and amortized over the estimated life of the loans as an adjustment of their yield through interest income using the interest method. When a loan is paid off or sold, any unamortized deferred fee (cost) is credited (charged) to income.

Credit card balances acquired as part of the FDIC-assisted acquisition are accounted for under the guidance of ASC 310-20, which requires that any differences between the contractually required loan payments in excess of the Group's initial investment in the loans be accreted into interest income on a level-yield basis over the life of the loan. Loans accounted for under ASC 310-20 are placed on non-accrual status when past due in accordance with the Group's non-accruing policy, and any accretion of discount is discontinued. These assets were written-down to their estimated fair value on their acquisition date, incorporating an estimate of future expected cash flows. To the extent actual or projected cash flows are less than originally estimated, additional provisions for loan and lease losses are recognized.

On April 1, 2011, the Bank changed on a prospective basis its policy to place on non-accrual status residential mortgage loans well collateralized and in process of collection when reaching 90 days past due. All loans that were between 90 and 365 days past due when the policy was changed were also placed on non-accrual status, and the interest receivable on such loans was evaluated on a periodic basis against the collateral underlying the loans and, if necessary, written-down. On December 31, 2011, the Bank further revised its policy to reverse against income all interest recorded on residential mortgage loans reaching 90 days past due, including the remaining interest on loans that were between 90 and 365 days past due as of April 1, 2011. On December 31, 2011, the Bank also charged-off this remaining accrued interest on residential mortgage loans over 90 days past due. This change in estimate was considered necessary to comply with guidance received from the Group's regulators.

For all other loans, interest recognition is discontinued when loans are 90 days or more in arrears on principal and/or interest based on contractual terms. Loans for which the recognition of interest income has been discontinued are designated as non-accruing. Collections are accounted for on the cash method thereafter, until qualifying to return to accrual status. Such loans are not reinstated to accrual status until interest is received on a current basis and other factors indicative of doubtful collection cease to exist.

The Group follows a systematic methodology to establish and evaluate the adequacy of the allowance for loan and lease losses to provide for inherent losses in the non-covered loan portfolio. This methodology includes the consideration of factors such as economic conditions, portfolio risk characteristics, prior loss experience, and results of periodic credit reviews of individual loans. The provision for loan and lease losses charged to current operations is based on such methodology. Loan and lease losses are charged and recoveries are credited to the allowance for loan and lease losses on non-covered loans.

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

Included in the review of individual loans are those that are impaired. A loan is considered impaired when, based on current information and events, it is probable that the Group will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral, if the loan is collateral dependent. Loans are individually evaluated for impairment, except large groups of small balance homogeneous loans that are collectively evaluated for impairment and loans that are recorded at fair value or at the lower of cost or fair value. The Group measures for impairment all commercial loans over $250 thousand (i) that are either over 90 days past due or adversely classified, or (ii) when deemed necessary by management. The portfolios of mortgage, leases and consumer loans are considered homogeneous, and are evaluated collectively for impairment.

The Group, using a rating system, applies an overall allowance percentage to each non-covered loan portfolio segment based on historical credit losses adjusted for current conditions and trends. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Group over the most recent twelve months. The actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: the credit grading assigned to commercial loans, levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff, including the bank's loan review system as graded by regulatory agencies in their last examination; local economic trends and conditions; industry conditions; effects of external factors such as competition and regulatory requirements on the level of estimated credit losses in the current portfolio; and effects of changes in credit concentrations and

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collateral value. The following portfolio segments have been identified: mortgage loans; commercial loans; consumer loans; and leasing.

Mortgage Loans: These loans are further divided into four classes: traditional mortgages, non-traditional mortgages, loans in loan modification programs and home equity secured personal loans. Traditional mortgage loans include loans secured by dwelling, fixed coupons and regular amortization schedules. Non-traditional mortgages include loans with interest-first amortization schedules and loans with balloon considerations as part of their terms. Mortgages in loan modification programs are loans that are being serviced under such programs. Home equity loans are mainly equity lines of credit. The allowance factor on these loans is impacted by the historical loss factors on the sub-segments, vintages, the environmental risk factors described above and by delinquency buckets. Due to the fact that the traditional mortgage sub-segment represented as of March 31, 2012 approximately 82.6% of the total mortgage loan portfolio, during this quarter the traditional mortgage loans were further segregated by vintages.

Commercial loans: These loans are further divided into two classes: commercial loans secured by existing commercial real estate properties and other commercial loans. The allowance factor assigned to these loans is impacted by historical loss factors, by the environmental risk factors described above and by the credit risk ratings assigned to the loans. These credit risk ratings are based on relevant information about the ability of borrowers to service their debt such as: economic conditions, portfolio risk characteristics, prior loss experience, and results of periodic credit reviews of individual loans.

Consumer loans: These consist of smaller retail loans such as retail credit cards, overdrafts, unsecured personal lines of credit, and personal unsecured loans. The allowance factor on these loans is impacted by the historical loss factors on the segment, the environmental risk factors described above and by delinquency buckets.

Leasing: This segment consists of personal loans guaranteed by vehicles in the form of lease financing. The allowance factor on these loans is impacted by the historical losses on the segment, the environmental risk factors described above and by delinquency buckets.

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

Covered Loans

Covered loans acquired in the FDIC-assisted acquisition are accounted under the provisions of ASC 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality," which is applicable when (a) the Group acquires loans deemed to be impaired when there is evidence of credit deterioration and it is probable, at the date of acquisition, that the Group would be unable to collect all contractually required payments and (b) as a general policy election for non-impaired loans that the Group acquired with some discount attributable to credit.

The acquired covered loans were recorded at their estimated fair value at the time of acquisition. Fair value of acquired loans is determined using a discounted cash flow model based on assumptions about the amount and timing of principal and interest payments, estimated prepayments, estimated default rates, estimated loss severity in the event of defaults, and current market rates. Estimated credit losses are included in the determination of fair value; therefore, an allowance for loan and lease losses is not recorded on the acquisition date.

In accordance with ASC 310-30 and in estimating the fair value of covered loans at the acquisition date, the Group (a) calculated the contractual amount and timing of undiscounted principal and interest payments (the "undiscounted contractual cash flows") and (b) estimated the amount and timing of undiscounted expected principal and interest payments (the "undiscounted expected cash flows"). The difference between the undiscounted contractual cash flows and the undiscounted expected cash flows is the non-accretable discount. The non-accretable discount represents an estimate of the loss exposure in the covered loan portfolio, and such amount is subject to change over time based on the performance of the covered loans. The carrying value of covered loans is reduced by payments received and increased by the portion of the accretable yield recognized as interest income.

The excess of undiscounted expected cash flows at acquisition over the initial fair value of acquired loans is referred to as the "accretable yield" and is recorded as interest income over the estimated life of the loans using the effective yield method if the timing and amount of the future cash flows is reasonably estimable. Subsequent to acquisition, the Group aggregates loans into pools of loans

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with common risk characteristics to account for the acquired loans. Increases in expected cash flows over those originally estimated increase the accretable yield and are recognized as interest income prospectively or reverse previously recognized allowance for loan and lease losses. Decreases in expected cash flows compared to those originally estimated decrease the accretable yield and are recognized by recording a provision for covered loan and lease losses and establishing an allowance for loan and lease losses.

ASC 310-30-40-1 states that, once a pool of loans is assembled, the integrity of the pool shall be maintained. A loan shall be removed from a pool of loans only if (a) the investor sells, forecloses, or otherwise receives assets in satisfaction of the loan or (b) the loan is written off. A refinancing or restructuring of a loan shall not result in the removal of a loan from a pool. Events that result in a loan being removed from a pool are often referred to as “confirming events.” When a confirming event occurs and a loan is removed from a pool, ASC 310-30 indicates that the loan should be removed at its carrying amount. ASC 310-30-35-15 states that, if a loan is removed from a pool of loans, the difference between the loan’s carrying amount and the fair value of the collateral or other assets received shall not affect the percentage yield calculation used to recognize accretable yield on the pool of loans. That is, the pool’s yield should be unaffected by the removal. The Group removes such loans on an “as expected” basis, which assumes cash or other assets received are equal to the original expectation of cash flows.

Under the accounting guidance of ASC 310-30 for acquired loans, the allowance for loan and lease losses on covered loans is measured at each financial reporting period, or measurement date, based on expected cash flows. Accordingly, decreases in expected cash flows on these loans compared to those expected cash flows previously forecasted are recognized by recording a provision for credit losses on covered loans. The portion of the loss on covered loans reimbursable from the FDIC is recorded as an offset to the provision for credit losses and increases the FDIC shared-loss indemnification asset.

Lease Financing

The Group leases vehicles for personal and commercial use to individual and corporate customers. The direct finance lease method of accounting is used to recognize revenue on leasing contracts that meet the criteria specified in the guidance for leases in ASC Topic 840. Aggregate rentals due over the term of the leases less unearned income are included in lease financing contracts receivable. Unearned income is amortized using a method over the average life of the leases as an adjustment to the interest yield.

Troubled Debt Restructuring

A troubled debt restructuring ("TDR") is the restructuring of a receivable in which the Group, as creditor, grants a concession for legal or economic reasons due to the debtor's financial difficulties. A concession is granted when, as a result of the restructuring, the Group does not expect to collect all amounts due, including interest accrued at the original contract rate. These concessions may include a reduction of the interest rate, principal or accrued interest, extension of the maturity date or other actions intended to minimize potential losses.

To assess whether the debtor is having financial difficulties, the Group evaluates whether it is probable that the debtor will default on any of its debt in the foreseeable future. If default is probable, then the debtor is considered to be experiencing financial difficulty even if there is no current default.

Receivables that are restructured in a TDR are presumed to be impaired and are subject to a specific impairment-measurement method. If the payment of principal at original maturity is primarily dependent on the value of collateral, the Group considers the current value of that collateral in determining whether the principal will be paid. For non-collateral dependent loans, the specific reserve is calculated based on the present value of expected cash flows discounted at the loan's effective interest rate. Loans modified in TDRs are placed on non-accrual status until the Group determines that future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrate performance according to the restructured terms for a period of at least six months.

Reserve for Unfunded Commitments

The reserve for unfunded commitments is maintained at a level believed by management to be sufficient to absorb estimated probable losses related to unfunded credit facilities and is included in other liabilities in the consolidated statements of condition. The determination of the adequacy of the reserve is based upon an evaluation of the unfunded credit facilities. Net adjustments to the reserve for unfunded commitments are included in other operating expenses in the consolidated statements of operations.

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FDIC Shared-Loss Indemnification Asset

The FDIC shared-loss indemnification asset is accounted for and measured separately from the covered loans acquired in the FDIC-assisted acquisition as it is not contractually embedded in any of the covered loans. The shared-loss indemnification asset related to estimated future loan and lease losses is not transferable should the Group sell a loan prior to foreclosure or maturity. The shared-loss indemnification asset was recorded at fair value at the acquisition date and represents the present value of the estimated cash payments expected to be received from the FDIC for future losses on covered assets, based on the credit adjustment estimated for each covered asset and the shared-loss percentages. This balance also includes incurred expenses under the shared-loss agreements. This asset is presented net of any clawback liability due to the FDIC under the Purchase and Assumption Agreement. These cash flows are then discounted at a market-based rate to reflect the uncertainty of the timing and receipt of the shared-loss reimbursements from the FDIC. The amount ultimately collected for this asset is dependent upon the performance of the underlying covered assets, the passage of time, and claims submitted to the FDIC. The time value of money incorporated into the present value computation is accreted into earnings over the shorter of the life of the shared-loss agreements or the holding period of the covered assets.

The FDIC shared-loss indemnification asset is reduced as losses are recognized on covered loans and shared-loss payments are received from the FDIC. Realized credit losses in excess of acquisition-date estimates result in an increase in the FDIC shared-loss indemnification asset. Conversely, if realized credit losses are less than acquisition-date estimates, the FDIC shared-loss indemnification asset is amortized through the term of the shared-loss agreements.

Core Deposit Intangible

Core deposit intangible (“CDI”) is a measure of the value of checking and savings deposits acquired in a business combination. The fair value of the CDI stemming from any given business combination is based on the present value of the expected cost savings attributable to the core deposit funding, relative to an alternative source of funding. CDI is amortized straight-line over a 10-year period. The Group evaluates such identifiable intangible for impairment when an indication of impairment exists. No impairment charges were required to be recorded in the quarters and six month periods ended June 30, 2012 and 2011.

Foreclosed Real Estate and Other Repossessed Property

Non-Covered Foreclosed Real Estate

Foreclosed real estate is initially recorded at the lower of the related loan balance or the fair value of the real estate less the cost of selling it at the date of foreclosure. At the time properties are acquired in full or partial satisfaction of loans, any excess of the loan balance over the estimated fair value of the property is charged against the allowance for loan and lease losses on non-covered loans. After foreclosure, these properties are carried at the lower of cost or fair value less estimated cost to sell, based on recent appraised values or options to purchase the foreclosed property. Any excess of the carrying value over the estimated fair value, less estimated costs to sell, is charged to non-interest expenses. The costs and expenses associated to holding these properties in portfolio are expensed as incurred.

Covered Foreclosed Real Estate and Other Repossessed Property

Covered foreclosed real estate and other repossessed property is initially recorded at their estimated fair value on the acquisition date, based on appraisal value less estimated selling costs. Any subsequent write-downs due to declines in fair value and costs and expenses associated to holding these properties in portfolio are charged as incurred to non-interest expense with a partially offsetting non-interest income for the loss reimbursement under the FDIC shared-loss agreement. Any recoveries of previous write downs are credited to non-interest expenses with a corresponding charge to non-interest income for the portion of the recovery that is due to the FDIC.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Income Taxes

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

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of the Group's net deferred tax assets assumes that the Group will be able to generate sufficient future taxable income based on estimates and assumptions. If these estimates and related assumptions change in the future, the Group may be required to record valuation allowances against its deferred tax assets resulting in additional income tax expense in the consolidated statements of operations.

Management evaluates on a regular basis whether the deferred tax assets can be realized and assesses the need for a valuation allowance. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Group's tax provision in the period of change.

In addition to valuation allowances, the Group establishes accruals for uncertain tax positions when, despite the belief that the Group's tax return positions are fully supported, the Group believes that certain positions are likely to be challenged. The accruals for uncertain tax positions are adjusted in light of changing facts and circumstances, such as the progress of tax audits, case law, and emerging legislation. The accruals for the Group's uncertain tax positions are reflected as income tax payable as a component of accrued expenses and other liabilities. These accruals are reduced upon expiration of the applicable statute of limitations.

The Group follows a two-step approach for recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation process, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement.

The Group's policy is to include interest and penalties related to unrecognized income tax benefits within the provision for income taxes on the consolidated statements of operations.

On January 31, 2011, the Governor of Puerto Rico signed into law the second and last phase of the Administration's tax reform bill. It creates the Internal Revenue Code for a New Puerto Rico, which has been subsequently amended several times (the "2011 Code"). The 2011 Code provides for the gradual repeal of the Puerto Rico Internal Revenue Code of 1994 (the "1994 Code"), as its provisions started to take effect, with some exceptions, as of January 1, 2011. For corporate taxpayers, the 2011 Code retains the 20% flat rate on "normal-tax net income" but establishes significantly lower rates applicable to "surtax net income" which is the "normal-tax net income" less the allowed surtax deduction. The 2011 Code provides a surtax rate from 5% to 10% for taxable years commencing after December 31, 2010 and before January 1, 2014. For taxable years commencing after December 31, 2013, the surtax rate may be reduced to 5% if certain economic and budgetary control tests are met by the Government of Puerto Rico. If such economic tests are not met, the reduction of the surtax rate will be postponed until the year when such economic tests are met. In the case of a controlled group of corporations, the determination of which surtax rate applies will be made by adding the "normal-tax net income" of each of the entities that are members of the controlled group reduced by the surtax deduction. The 2011 Code also increased the surtax deduction to $750,000. In the case of a controlled group of corporations, the surtax deduction should be distributed among the members of the controlled group. The 2011 Code reduces the alternative minimum tax ("AMT") from 22% to 20%. It also eliminates the 5% additional surtax which was established by Act No. 7 of March 9, 2009, and the 5% recapture of the benefit of the income tax tables, except for income earned by international banking entities, which was fully exempt and is subject to a 5% income tax for the taxable years beginning after December 31, 2008 and ending before January 1, 2012. Under the 2011 Code, a corporate taxpayer has a one-time option of determining its income tax liability and filing its income tax return pursuant to the 1994 Code. This election must be made with the filing of the 2011 income tax return and, once made, is irrevocable for the taxable year when the election is made

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

and for each of the next four taxable years. The Group decided to implement the 2011 Code. Under the 2011 Code, all companies are treated as separate taxable entities and are not entitled to file consolidated returns. The Group and its subsidiaries are subject to Puerto Rico regular income tax or AMT on income earned from all sources. The AMT is payable if it exceeds regular income tax. The excess of AMT over regular income tax paid in any one year may be used to offset regular income tax in future years, subject to certain limitations.

Equity-Based Compensation Plan

The Group's Amended and Restated 2007 Omnibus Performance Incentive Plan (the "Omnibus Plan") provides for equity-based compensation incentives through the grant of stock options, stock appreciation rights, restricted stock, restricted units and dividend equivalents, as well as equity-based performance awards. The Omnibus Plan was adopted in 2007, amended and restated in 2008, and further amended in 2010.

The purpose of the Omnibus Plan is to provide flexibility to the Group to attract, retain and motivate directors, officers, and key employees through the grant of awards based on performance and to adjust its compensation practices to the best compensation practice and corporate governance trends as they develop from time to time. The Omnibus Plan is further intended to motivate high levels of individual performance coupled with increased shareholder returns. Therefore, awards under the Omnibus Plan (each, an "Award") are intended to be based upon the recipient's individual performance, level of responsibility and potential to make significant contributions to the Group. Generally, the Omnibus Plan will terminate as of (a) the date when no more of the Group's shares of common stock are available for issuance under the Omnibus Plan, or, (b) if earlier, the date the Omnibus Plan is terminated by the Group's Board of Directors.

The Board's Compensation Committee (the "Committee"), or such other committee as the Board may designate, has full authority to interpret and administer the Omnibus Plan in order to carry out its provisions and purposes. The Committee has the authority to determine those persons eligible to receive an Award and to establish the terms and conditions of any Award. The Committee may delegate, subject to such terms or conditions or guidelines as it shall determine, to any employee or group of employees any portion of its authority and powers under the Omnibus Plan with respect to participants who are not directors or executive officers subject to the reporting requirements under Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Only the Committee may exercise authority in respect of Awards granted to such participants.

The Omnibus Plan replaced and superseded the Group's 1996, 1998 and 2000 Incentive Stock Option Plans (the "Stock Option Plans"). All outstanding stock options under the Stock Option Plans continue in full force and effect, subject to their original terms and conditions.

The expected term of stock options granted represents the period of time that such options are expected to be outstanding. Expected volatilities are based on historical volatility of the Group's shares of common stock over the most recent period equal to the expected term of the stock options. For stock options issued during 2012, the expected volatilities are based on both historical and implied volatility of the Group's shares of common stock.

The Group follows the fair value method of recording stock-based compensation. The Group uses the modified prospective transition method, which requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award with the cost to be recognized over the service period. It applies to all awards unvested and granted after this effective date and awards modified, repurchased, or cancelled after that date.

Subsequent Events

The Group has evaluated other events subsequent to the balance sheet date and prior to the filing of this quarterly report on Form 10-Q for the quarter ended June 30, 2012, and has adjusted and disclosed those events that have occurred that would require adjustment or disclosure in the unaudited consolidated financial statements.

Reclassifications

When necessary, certain reclassifications have been made to prior year amounts to conform to the current year presentation.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Recent Accounting Developments

Comprehensive Income — FASB Accounting Standards Update ("ASU") 2011-12, "Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05" (Topic 220) was issued in December 2011. This update defers the effective date for the presentation of reclassification adjustments. The amendments are being made to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated comprehensive income on the components of net income and other comprehensive income for all periods presented. The amendments in this update are effective for interim and annual reporting periods beginning after December 15, 2011. The Group adopted this guidance for the deferment of the presentation of reclassifications of items out of accumulated comprehensive income.

Fair Value Measurement — FASB ASU 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" (Topic 820) was issued in May 2011. This update establishes common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Among the changes, additional information about the sensitivity of a fair value measurement categorized within Level 3 of the fair value hierarchy to changes in unobservable inputs and any interrelationships between those unobservable inputs will be required. Also, entities now will be required to categorize by level of the fair value hierarchy items that are not measured at fair value in the statement of financial position, but for which the fair value of such items is required to be disclosed. The amendments in this update are effective during interim and annual periods beginning after December 15, 2011, are to be applied prospectively. The Group adopted this guidance for fair value measurements.

Repurchase Agreements — FASB ASU 2011-03, "Reconsideration of Effective Control for Repurchase Agreements" (Topic 860) was issued in April 2011. This update removes from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by the amendments in this update. The amendments in this update are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption was not permitted. The Group adopted this guidance for the repurchase agreements.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 2 - FDIC-ASSISTED ACQUISITION AND FDIC SHARED-LOSS INDEMNIFICATION ASSET

On April 30, 2010, the Bank acquired certain assets and assumed certain deposits and other liabilities of Eurobank from the FDIC as receiver of Eurobank, San Juan, Puerto Rico. As part of the Purchase and Assumption Agreement between the Bank and the FDIC (the "Purchase and Assumption Agreement"), the Bank and the FDIC entered into shared-loss agreements, whereby the FDIC covers a substantial portion of any losses on loans (and related unfunded loan commitments), foreclosed real estate and other repossessed properties.

The acquired loans, foreclosed real estate, and other repossessed property subject to the shared-loss agreements are collectively referred to as "covered assets." Under the terms of the shared-loss agreements, the FDIC absorbs 80% of losses and shares in 80% of loss recoveries on covered assets. The term of the shared-loss agreement covering single family residential mortgage loans is ten years with respect to losses and loss recoveries, while the term of the shared-loss agreement covering commercial loans is five years with respect to losses and eight years with respect to loss recoveries, from the April 30, 2010 acquisition date. The shared-loss agreements also provide for certain costs directly related to the collection and preservation of covered assets to be reimbursed at an 80% level.

The assets acquired and liabilities assumed as of April 30, 2010 were presented at their fair value. In many cases, the determination of these fair values required management to make estimates about discount rates, expected cash flows, market conditions and other future events that are highly subjective in nature and were subject to change. The fair values initially assigned to the assets acquired and liabilities assumed were preliminary and subject to refinement for up to one year after the closing date of the acquisition as new information relative to closing date fair values became available. The process was completed on April 29, 2011.

The Bank has agreed to make a true-up payment, also known as clawback liability, to the FDIC on the date that is 45 days following the last day (such day, the "True-Up Measurement Date") of the final shared-loss month, or upon the final disposition of all covered assets under the shared-loss agreements in the event losses thereunder fail to reach expected levels. Under the shared-loss agreements, the Bank will pay to the FDIC 50% of the excess, if any, of: (i) 20% of the Intrinsic Loss Estimate of $906.0 million (or $181.2 million) (as determined by the FDIC) less (ii) the sum of: (A) 25% of the asset discount (per bid) (or $227.5 million); plus (B) 25% of the cumulative shared-loss payments (defined as the aggregate of all of the payments made or payable to the Bank minus the aggregate of all of the payments made or payable to the FDIC); plus (C) the sum of the period servicing amounts for every consecutive twelve-month period prior to and ending on the True-Up Measurement Date in respect of each of the shared-loss agreements during which the shared-loss provisions of the applicable shared-loss agreement is in effect (defined as the product of the simple average of the principal amount of shared-loss loans and shared-loss assets at the beginning and end of such period times 1%). The true-up payment represents an estimated liability of $14.3 million and $13.3 million, net of discount, as of June 30, 2012 and December 31, 2011, respectively. This estimated liability is accounted for as a reduction of the indemnification asset. The indemnification asset represents the portion of estimated losses covered by the shared-loss agreements between the Bank and the FDIC.

The operating results of the Group for the quarters and six-month periods ended June 30, 2012 and 2011 include the operating results produced by the acquired assets and assumed liabilities.

The FDIC shared-loss indemnification asset activity for the six-month periods ended June 30, 2012 and 2011 is as follows:

	Six-Month Period Ended June 30,	
	2012	2011
	(In thousands)	
Balance at beginning of period	$ 392,367	$ 471,872
Shared-loss agreements reimbursements from the FDIC	(39,729)	(39,870)
Recoveries on expected credit impairment losses to be covered under shared-loss agreements, net	12,748	3,201
Accretion (amortization) of FDIC shared-loss indemnification asset, net	(10,410)	2,231
Incurred expenses to be reimbursed under shared-loss agreements	4,791	3,199
Balance at end of period	**$ 359,767**	**$ 440,633**

ORIENTAL FINANCIAL GROUP INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 3 - INVESTMENTS

Money Market Investments

The Group considers as cash equivalents all money market instruments that are not pledged and that have maturities of three months or less at the date of acquisition. At June 30, 2012 and December 31, 2011, money market instruments included as part of cash and cash equivalents amounted to $4.7 million and $3.9 million, respectively.

Securities Purchased Under Agreements to Resell

Securities purchased under agreements to resell consist of short-term investments and are carried at the amounts at which the assets will be subsequently resold as specified in the respective agreements. At June 30, 2012, securities purchased under agreements to resell amounted to $225.0 million. At December 31, 2011, there were no securities purchased under agreements to resell.

The amounts advanced under those agreements are reflected as assets in the unaudited consolidated statements of financial condition. It is the Group's policy to take possession of securities purchased under agreements to resell. Agreements with third parties specify the Group's rights to request additional collateral based on its monitoring of the fair value of the underlying securities on a daily basis. The fair value of the collateral securities held by the Group on these transactions as of June 30, 2012 was approximately $219.2 million.

Investment Securities

The amortized cost, gross unrealized gains and losses, fair value, and weighted average yield of the securities owned by the Group at June 30, 2012 and December 31, 2011 were as follows:

	June 30, 2012				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
	(In thousands)				
Available-for-sale					
Mortgage-backed securities					
	$ 2,052,066	$ 82,400	$ -	$ 2,134,466	3.41%

FNMA and FHLMC certificates					
GNMA certificates	20,952	1,539	-	22,491	4.86%
CMOs issued by US Government sponsored agencies	206,110	876	189	206,797	1.81%
Total mortgage-backed securities	**2,279,128**	**84,815**	**189**	**2,363,754**	**3.28%**
Investment securities					
US Treasury securities	154,998	-	-	154,998	0.06%
Obligations of US Government sponsored agencies	28,629	162	-	28,791	1.46%
Obligations of Puerto Rico Government and					
political subdivisions	22,221	150	19	22,352	5.41%
Structured credit investments	36,407	-	9,127	27,280	2.12%
Other debt securities	15,389	275	-	15,664	3.42%
Total investment securities	**257,644**	**587**	**9,146**	**249,085**	**1.17%**
Total securities available-for-sale	**2,536,772**	**85,402**	**9,335**	**2,612,839**	**3.06%**
Held-to-maturity					
Mortgage-backed securities					
FNMA and FHLMC certificates	778,903	28,541	-	807,444	3.30%
CMOs issued by US Government sponsored agencies	116,597	1,225	-	117,822	1.98%
Total securities held-to-maturity	**895,500**	**29,766**	**-**	**925,266**	**3.13%**
Total	**$ 3,432,272**	**$ 115,168**	**$ 9,335**	**$ 3,538,105**	**3.08%**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

	December 31, 2011				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
			(In thousands)		
Available-for-sale					
Mortgage-backed securities					
FNMA and FHLMC certificates	$ 2,583,881	$ 92,899	$ -	$ 2,676,780	3.61%
GNMA certificates	26,186	2,151	-	28,337	5.94%
CMOs issued by US Government sponsored agencies	128,505	1,739	199	130,045	2.33%
Total mortgage-backed securities	**2,738,572**	**96,789**	**199**	**2,835,162**	**3.57%**
Investment securities					
Obligations of Puerto Rico Government and					
political subdivisions	72,437	225	1,204	71,458	5.37%
Structured credit investments	46,904	-	9,616	37,288	2.92%
Other debt securities	15,769	235	-	16,004	3.42%
Total investment securities	**135,110**	**460**	**10,820**	**124,750**	4.29%
Total securities available-for-sale	**2,873,682**	**97,249**	**11,019**	**2,959,912**	**3.60%**
Held-to-maturity					
Mortgage-backed securities					
FNMA and FHLMC certificates	884,026	20,530	-	904,556	3.34%
Total	**$ 3,757,708**	**$ 117,779**	**$ 11,019**	**$ 3,864,468**	**3.54%**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The amortized cost and fair value of the Group's investment securities at June 30, 2012, by contractual maturity, are shown in the next table. Securities not due on a single contractual maturity date, such as collateralized mortgage obligations, are classified in the period of final contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2012			
	Available-for-sale		Held-to-maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Mortgage-backed securities				
Due after 5 to 10 years				
FNMA and FHLMC certificates	$ 49,055	$ 50,294	$ -	$ -
Total due after 5 to 10 years	**49,055**	**50,294**	**-**	**-**
Due after 10 years				
FNMA and FHLMC certificates	2,003,011	2,084,172	778,903	807,444
GNMA certificates	20,952	22,491	-	-
CMOs issued by US Government sponsored agencies	206,110	206,797	116,597	117,822
Total due after 10 years	**2,230,073**	**2,313,460**	**895,500**	**925,266**
Total mortgage-backed securities	**2,279,128**	**2,363,754**	**895,500**	**925,266**
Investment securities				
Due in less than one year				
US Treasury securities	154,998	154,998	-	-
Total due in less than one year	**154,998**	**154,998**	**-**	**-**
Due from 1 to 5 years				
Other debt securities	10,000	10,016	-	-
Total due from 1 to 5 years	**10,000**	**10,016**	**-**	**-**
Due after 5 to 10 years				
Obligations of Puerto Rico Government and political subdivisions	11,760	11,837	-	-
Structured credit investments	36,407	27,280		
Obligations of US Government and sponsored agencies	28,629	28,791	-	-
	76,796	**67,908**	**-**	**-**

Total due after 5 to 10 years								
Due after 10 years								
Obligations of Puerto Rico Government and political subdivisions		10,461		10,515		-		-
Other debt securities		5,389		5,648		-		-
Total due after 10 years		**15,850**		**16,163**		**-**		**-**
Total investment securities		**257,644**		**249,085**		**-**		**-**
Total	**$**	**2,536,772**	**$**	**2,612,839**	**$**	**895,500**	**$**	**925,266**

Keeping with the Group's investment strategy, during the six-month periods ended June 30, 2012 and 2011, there were certain sales of available-for sale securities because the Group felt at the time of such sales that gains could be realized while at the same time having good opportunities to invest the proceeds in other investment securities with attractive yields and terms that would allow the Group to continue to protect its net interest margin. The Group is also pursuing the strategy of selling securities subject to higher prepayment speeds.

The Group, as part of its asset/liability management, may purchase US Treasury securities and US government sponsored agencies discount notes close to their maturities as a short term vehicle to reinvest the proceeds of sale transactions until investment securities with attractive yields can be purchased.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Group recorded a net gain on sale of securities of $19.3 million and $9.1 million during the six-month periods ended June 30, 2012 and 2011, respectively. The tables below present the gross realized gains and losses by category for the six-month periods ended June 30, 2012 and 2011:

	Six-Month Period Ended June 30, 2012			
Description	**Sale Price**	**Book Value at Sale**	**Gross Gains**	**Gross Losses**
	(In thousands)			
Sale of Securities Available-for-Sale				
Mortgage-backed securities				
FNMA and FHLMC certificates	$ 367,981	$ 349,400	$ 18,581	$ -
GNMA certificates	39,484	39,483	1	-
CMOs issued by US Government sponsored agencies	19,725	18,372	1,353	-
Total mortgage-backed securities and CMOs	427,190	407,255	19,935	-
Investment securities				
US Treasury securities	80,000	80,000	-	-
Obligations of Puerto Rico Government and political subdivisions	35,882	36,478	31	628
Structured credit investments	10,530	10,530	-	-
Total investment securities	126,412	127,008	31	628
Total	**$ 553,602**	**$ 534,263**	**$ 19,966**	**$ 628**

	Six-Month Period Ended June 30, 2011			
Description	**Sale Price**	**Sale Book Value**	**Gross Gains**	**Gross Losses**
	(In thousands)			
Sale of Securities Available-for-Sale				
Mortgage-backed securities				
FNMA and FHLMC certificates	$ 153,740	$ 145,619	$ 8,121	$ -
GNMA certificates	84,996	83,987	1,011	2
Total mortgage-backed securities	238,736	229,606	9,132	2
Investment securities				
Obligations of U.S. Government sponsored agencies	14,100	14,100	-	-
Total investment securities	14,100	14,100	-	-
Total	**$ 252,836**	**$ 243,706**	**$ 9,132**	**$ 2**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following tables show the Group's gross unrealized losses and fair value of investment securities available-for-sale and held-to-maturity, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2012 and December 31, 2011:

	June 30, 2012		
	12 months or more		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
		(In thousands)	
Securities Available-for-sale			
Structured credit investments	$ 36,407	$ 9,127	$ 27,280
Obligations of Puerto Rico Government and political subdivisions	1,635	19	1,616
CMOs issued by US Government sponsored agencies	2,288	189	2,099
	$ 40,330	**$ 9,335**	**$ 30,995**

	December 31, 2011		
	12 months or more		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
		(In thousands)	
Securities Available-for-sale			
Structured credit investments	$ 36,374	$ 9,616	$ 26,758
Obligations of Puerto Rico Government and political subdivisions	24,697	1,204	23,493
CMOs issued by US Government sponsored agencies	2,384	199	2,185
	$ **63,455**	$ **11,019**	$ **52,436**

At June 30, 2012 and December 31, 2011, there were no available-for-sale securities in a continuous unrealized loss position for less than 12 months. In addition, at June 30, 2012 and December 31, 2011, there were no individual held-to-maturity securities in an unrealized loss position.

The Group conducts quarterly reviews to identify and evaluate each investment in an unrealized loss position for other-than-temporary impairment.

Any portion of a decline in value associated with credit loss is recognized in income with the remaining noncredit-related component recognized in other comprehensive income. A credit loss is determined by assessing whether the amortized cost basis of the security will be recovered, by comparing the present value of cash flows expected to be collected from the security, discounted at the rate equal to the yield used to accrete current and prospective beneficial interest for the security. The shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis is considered to be the "credit loss."

Other-than-temporary impairment analysis is based on estimates that depend on market conditions, and are subject to further change over time. In addition, while the Group believes that the methodology used to value these exposures is reasonable, the methodology is subject to continuing refinement, including those made as a result of market developments. Consequently, it is reasonably possible that changes in estimates or conditions could result in the need to recognize additional other-than-temporary impairment charges in the future.

At June 30, 2012, the Group’s portfolio of structured credit investments amounted to $36.4 million (amortized cost) in the available-for-sale portfolio, with net unrealized losses of approximately $9.1 million. The Group’s structured credit investments portfolio consist of three collateralized loan obligations (CLOs).

The CLOs are collateralized mostly by senior secured (via first liens) “middle market” commercial and industrial loans, which are securitized in the form of obligations. These investments are all floating rate notes, which reset quarterly based on the three-month LIBOR rate.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The determination of the credit loss assumption in the discounted cash flow analysis related to the Group's structured credit investments is based on the underlying data for each type of security. In the case of the CLOs, the determination of the future cash flows is based on the following factors:

• Identification of the estimated fair value of the contractual coupon of the loans underlying the CLO. Such fair values are calculated based on information that is obtained directly from the trustee's reports for each CLO security.

• Calculation of the yield-to-maturity for each loan in the CLO, and determination of the interest rate spread (yield less the risk-free rate).

• Estimated default probabilities for each loan in the CLO. These are based on the credit ratings for each company in the structure, and this information also is obtained directly from the trustee's reports for each CLO security. The default probabilities are adjusted based on the credit rating assuming the highest default probabilities for the loans of those entities with the lowest credit ratings. In addition to determining the current default probabilities, estimates are developed to calculate the cumulative default probabilities in successive years. To establish the reasonability of the default estimates, market-implied default rates are compared to historical credit ratings-based default rates.

• Once the default probabilities are estimated, the average numbers of defaults is calculated for the loans underlying each CLO security. In those cases where defaults are deemed to occur, a recovery rate is applied to the cash flow determination at the time in which the default is expected to occur. The recovery rate is based on average historical information for similar securities, as well as the actual recovery rates for defaults that have occurred within the pool of loans underlying the securities owned by the Group.

• One hundred simulations are carried out and run through a cash flow engine for the underlying pool of loans in each CLO security. Each one of the simulations uses different default estimates and forward yield curve assumptions.

The three CLOs held by the Group have face values of $12 million, $10 million and $15 million. In light of the other-than-temporary impairment analyses described below, the Group has determined that it is more likely than not that it will recover all interest and principal invested in the CLOs.

The cash flow analysis performed by the Group for the $12 million CLO did not reflect any scenario where there was a principal impairment. Moreover, on November 23, 2011, S&P increased its rating to "AA-" from "A+," and on November 6, 2011, Moody's increased its rating to "A2" from "Baa1," In addition, as of June 30, 2012 and December 31, 2011, respectively, the CLO's subordination level is 26.18%.

With respect to the $10 million CLO, the cash flow analysis performed by the Group also did not reflect any scenario where there was a principal impairment. On February 6, 2012, S&P increased its rating to "A+" from "A," and on November 2, 2011, Moody's increased its rating to "A2" from "A3." Also, as of June 30, 2012 and December 31, 2011, respectively, the CLO’s subordination level is 20.64%.

The cash flow analysis performed by the Group for the $15 million CLO detected that there was a principal impairment in 20 out of 100 scenarios, with average losses of 9.44% and 3 scenarios where the impairment amount is 100% of the Group’s investment. On August 3, 2011, Moody’s upgraded its rating to “Baa2” from “Baa3.” There have been no other credit actions by S&P since March 4, 2010, when they lowered its rating from “A-” to “BBB+,” which is still investment grade. Also, as of June 30, 2012 and December 31, 2011, respectively, the CLO’s subordination level is 7.54%.

The Group estimates that it will recover all interest and principal for the Group’s specific tranches of these securities. This assessment is based on the cash flow analysis mentioned above in which the credit quality of the Group’s positions was evaluated through a determination of the expected losses on the underlying collateral. The model results show that the estimated future collateral losses, if any, are lower than the Group’s subordination levels for each one of these securities. Therefore, these securities are deemed to have sufficient credit support to absorb the estimated collateral losses.

On January 12, 2012, the Group made the strategic decision to sell its $25.5 million investment in a corporate bond that was partially invested in a synthetic collateralized debt obligation (CDO) at a loss of $15.0 million. This loss was accounted for as an other-than-temporary impairment in the fourth quarter of 2011, and no additional gain or loss was realized on the sale in January 2012, since this asset was sold at the same value reflected at December 31, 2011. The main considerations underlying the Group’s decision to sell the security included the continued deteriorating credit conditions surrounding the underlying reference portfolio of the CDO, including an event of default that occurred during the fourth quarter of 2011, and the projected analysis prepared by a third-party specialist that

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showed defaults in excess of the deal's subordination level in more than 50% of the scenarios modeled. The corporate bond sold was a unique and completely distinguishable investment from the rest of the Group's portfolio, including the remaining structured credit investments. As a result of this transaction, the Group continued to reduce its exposure to non-agency securities, as well as to credit risk in the U.S. economy, and also was able to improve its risk-based capital position.

Other securities in an unrealized loss position at June 30, 2012 are mainly composed of highly liquid securities that in most cases have a large and efficient secondary market. Valuations are performed on a monthly basis. The Group's management believes that the unrealized losses of such other securities at June 30, 2012 are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuer or guarantor. At June 30, 2012, the Group does not have the intent to sell these investments in an unrealized loss position.

NOTE 4 - PLEDGED ASSETS

The following table shows a summary of pledged and not pledged assets at June 30, 2012 and December 31, 2011. Investment securities are presented at fair value, and residential mortgage loans, commercial loans and leases are presented at amortized cost:

		June 30, 2012		**December 31, 2011**
		(In thousands)		
Pledged investment securities to secure:				
Securities sold under agreements to repurchase	$	3,334,812	$	3,399,145
Puerto Rico public fund deposits		11,324		71,863
Puerto Rico Cash & Money Market Fund		71,202		62,739
Interest rate risk swap contracts		61,807		56,189
Federal Reserve Bank Credit Facility		11,936		15,560
Bond for the Bank's trust operations		125		126
Total pledged investment securities		**3,491,206**		**3,605,622**
Pledged residential mortgage loans to secure:				
Advances from the Federal Home Loan Bank		**522,148**		**548,809**
Pledged commercial loans to secure:				
Advances from the Federal Home Loan Bank		**50,504**		**40,937**
Pledged leases to secure:				
Federal Reserve Bank Credit Facility		**9,668**		**7,821**
Total pledged assets	**$**	**4,073,526**	**$**	**4,203,189**
Financial assets not pledged:				
Investment securities	$	266,071		