ORIENTAL FINANCIAL GROUP INC
Form 10-Q
August 08, 2011

Table of Contents

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

(Mark One)

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

For the quarterly period ended June 30, 2011

or

o **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 þ No o

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).

Yesþ Noo

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

Large Accelerated Filer o	Accelerated Filer þ	Non-Accelerated Filer o	Smaller Reporting Company o
		(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 o Noþ

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

44,011,107 common shares ($1.00 par value per share) outstanding as of July 31, 2011

TABLE OF CONTENTS

Table of Contents

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 Oriental Financial Group Inc s. (the Group) financial condition, results of operations, plans, objectives, future performance and business, including, but not limited to, statements with respect to the adequacy of the allowance for loan and lease 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 a expressions and future or conditional verbs such as will, would, should, could, might, can, may, or similar are generally intended to identify forward-looking statements.

These 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. government or a downgrade in the credit ratings of the U.S. government;
- 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 our 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; and
- possible legislative, tax or regulatory changes.

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.

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
JUNE 30, 2011 AND DECEMBER 31, 2010

	June 30, 2011	December 31, 2010
	(In thousands, except share data)	
ASSETS		
Cash and cash equivalents		
Cash and due from banks	$ 278,466	$ 337,218
Money market investments	2,563	111,728
Total cash and cash equivalents	**281,029**	**448,946**
Investments:		
Trading securities, at fair value, with amortized cost of $874 (December 31, 2010 - $1,306)	864	1,330
Investment securities available-for-sale, at fair value, with amortized cost of $3,529,671 (December 31, 2010 - $3,661,146)	3,581,087	3,700,064
Investment securities held-to-maturity, at amortized cost, with fair value of $858,226 (December 31, 2010 - $675,721)	863,779	689,917
Federal Home Loan Bank (FHLB) stock, at cost	23,779	22,496
Other investments	150	150
Total investments	**4,469,659**	**4,413,957**
Loans:		
Mortgage loans held-for-sale, at lower of cost or fair value	34,246	33,979
Loans not covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of $34,229 (December 31, 2010 - $31,430)	1,130,460	1,117,889
Loans covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of $53,036 (December 31, 2010 - $49,286)	542,543	620,711
Total loans, net	**1,707,249**	**1,772,579**
FDIC shared-loss indemnification asset	437,434	471,872
Foreclosed real estate covered under shared-loss agreements with the FDIC	16,918	14,871
Foreclosed real estate not covered uder shared-loss agreements with the FDIC	12,031	11,969
Accrued interest receivable	26,430	28,716
Deferred tax asset, net	32,637	30,732
Premises and equipment, net	23,649	23,941
Derivative assets	12,015	28,315
Other assets	63,496	64,826
Total assets	**$ 7,082,547**	**$ 7,310,724**

LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Demand deposits	$ 948,764	$ 954,554
Savings accounts	241,553	235,690
Certificates of deposit	1,194,914	1,398,644
Total deposits	**2,385,231**	**2,588,888**
Borrowings:		
Short-term borrowings	31,812	42,470
Securities sold under agreements to repurchase	3,459,135	3,456,781
Advances from FHLB	281,747	281,753
FDIC-guaranteed term notes	105,834	105,834
Subordinated capital notes	36,083	36,083
Total borrowings	**3,914,611**	**3,922,921**
FDIC net settlement payable	602	22,954
Derivative liabilities	13,918	64
Accrued expenses and other liabilities	43,828	43,566
Total liabilities	**6,358,190**	**6,578,393**
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; 47,808,284 shares issued; 44,009,380 shares outstanding (December 31, 2010 - 47,807,734; 46,348,667)	47,808	47,808
Treasury stock, at cost, 3,798,904 shares (December 31, 2010 - 1,459,067 shares)	(45,386)	(16,732)
Additional paid-in capital	498,556	498,435
Legal surplus	49,414	46,331
Retained earnings	71,091	51,502
Accumulated other comprehensive income, net of tax of $2,799 (December 31, 2010 - $2,107)	34,874	36,987
Total stockholders equity	**724,357**	**732,331**
Total liabilities and stockholders equity	**$ 7,082,547**	**$ 7,310,724**

See notes to unaudited consolidated financial statements.

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2011	2010	2011	2010
	(In thousands, except per share data)			
Interest income:				
Loans				
Loans not covered under shared-loss agreements with the FDIC	$ 15,969	$ 17,813	$ 33,808	$ 35,450
Loans covered under shared-loss agreements with the FDIC	13,060	11,587	27,285	11,586
Mortgage-backed securities	51,021	41,519	94,759	85,113
Investment securities and other	2,152	8,925	4,258	18,030
Total interest income	**82,202**	**79,844**	**160,110**	**150,179**
Interest expense:				
Deposits	11,588	11,951	23,802	23,194
Securities sold under agreements to repurchase	23,512	25,487	47,671	50,772
Advances from FHLB and other borrowings	3,061	3,053	6,110	6,065
Note payable to the FDIC		1,064		1,064
FDIC-guaranteed term notes	1,021	1,021	2,042	2,042
Subordinated capital notes	308	305	611	603
Total interest expense	**39,490**	**42,881**	**80,236**	**83,740**
Net interest income	**42,712**	**36,963**	**79,874**	**66,439**
Provision for non-covered loan and lease losses	3,800	4,100	7,600	8,114
Provision for covered loan and lease losses, net			549	
Net interest income after provision for loan and lease losses	**38,912**	**32,863**	**71,725**	**58,325**
Non-interest income:				
Wealth management revenues	4,572	4,659	9,255	8,637
Banking service revenues	3,306	3,041	7,143	4,663
Mortgage banking activities	2,435	2,339	4,394	4,136
Total banking and wealth management revenues	**10,313**	**10,039**	**20,792**	**17,436**
Total loss on other-than-temporarily impaired securities		(1,796)		(41,386)
Portion of loss on securities recognized in other comprehensive income				38,958

Other-than-temporary impairments on securities		(1,796)		(2,428)
Accretion of FDIC loss-share indemnification asset	1,020	1,314	2,231	1,314
Fair value adjustment on FDIC equity appreciation instrument		909		909
Net gain (loss) on:				
Sale of securities	9,132	11,833	9,130	23,853
Derivatives	(3,603)	(26,615)	(7,571)	(37,251)
Trading securities	(6)	1	(37)	(2)
Foreclosed real estate	(3)	(26)	(135)	(143)
Other	7	7	(20)	17
Total non-interest income (loss), net	**16,860**	**(4,334)**	**24,390**	**3,705**

See notes to unaudited consolidated financial statements.

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2011	2010	2011	2010
	(In thousands, except per share data)			
Non-interest expenses:				
Compensation and employee benefits	11,230	10,433	22,918	18,683
Professional and service fees	5,750	3,920	11,201	6,073
Occupancy and equipment	4,214	4,404	8,619	7,998
Insurance	1,646	1,733	3,632	3,566
Electronic banking charges	1,155	1,112	2,610	1,791
Taxes, other than payroll and income taxes	858	1,261	2,237	2,118
Advertising, business promotion, and strategic initiatives	1,508	1,364	2,700	2,064
Loan servicing and clearing expenses	1,076	793	2,097	1,518
Foreclosure and repossession expenses	761	523	1,490	825
Communication	425	735	822	1,078
Director and investors relations	339	388	625	703
Printing, postage, stationery and supplies	362	292	644	495
Other	1,372	892	1,891	1,330
Total non-interest expenses	**30,696**	**27,850**	**61,486**	**48,242**
Income before income taxes	**25,076**	**679**	**34,629**	**13,788**
Income tax expense (benefit)	(1,391)	34	5,081	1,206
Net income	**26,467**	**645**	**29,548**	**12,582**
Less: Dividends on preferred stock	(1,200)	(1,733)	(2,401)	(2,934)
Less: Allocation of undistributed earnings for participating preferred shares		(3,104)		(3,104)
Income available (loss) to common shareholders	**$ 25,267**	**$ (4,192)**	**$ 27,147**	**$ 6,544**
Income (loss) per common share:				
Basic	**$ 0.56**	**$ (0.13)**	**$ 0.60**	**$ 0.22**
Diluted	**$ 0.56**	**$ (0.13)**	**$ 0.59**	**$ 0.22**
Average common shares outstanding and equivalents	**45,135**	**33,053**	**45,656**	**29,471**
Cash dividends per share of common stock	**$ 0.05**	**$ 0.04**	**$ 0.10**	**$ 0.08**

See notes to unaudited consolidated financial statements.

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2011	2010	2011	2010
	(In thousands)		(In thousands)	
Net income	**$ 26,467**	**$ 645**	**$ 29,548**	**$ 12,582**
Other comprehensive income (loss):				
Unrealized gain on securities available-for-sale arising during the period	35,365	94,763	21,627	139,373
Realized gain on investment securities included in net income	(9,132)	(11,833)	(9,130)	(23,853)
Total loss on other- than-temporarily impaired securities		1,796		41,386
Portion of loss on securities recognized in other comprehensive income				(38,958)
Unrealized losses on cash flow hedges arising during the period	(21,041)		(13,918)	
Income tax effect	(637)	(6,368)	(692)	(9,847)
Other comprehensive income (loss) for the period	**4,555**	**78,358**	**(2,113)**	**108,101**
Comprehensive income	**$ 31,022**	**$ 79,003**	**$ 27,435**	**$ 120,683**

See notes to unaudited consolidated financial statements.

4

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Six-Month Period Ended June 30,	
	2011	**2010**
	(In thousands)	
Preferred stock:		
Balance at beginning of period	$ 68,000	$ 68,000
Issuance of preferred stock		177,289
Balance at end of period	**68,000**	**245,289**
Additional paid-in capital from beneficial conversion feature		
Balance at beginning of period		
Issuance of preferred stock beneficial conversion feature		22,711
Balance at end of period		**22,711**
Common stock:		
Balance at beginning of period	47,808	25,739
Issuance of common stock		8,740
Exercised stock options		2
Balance at end of period	**47,808**	**34,481**
Additional paid-in capital:		
Balance at beginning of period	498,435	213,445
Issuance of common stock		90,896
Exercised stock options		19
Stock-based compensation expense	682	546
Common stock issuance costs		(5,246)
Preferred stock issuance costs		(10,911)
Exercised restricted stock units with treasury shares	(561)	
Balance at end of period	**498,556**	**288,749**
Legal surplus:		
Balance at beginning of period	46,331	45,279
Transfer from retained earnings	3,083	1,376
Balance at end of period	**49,414**	**46,655**
Retained earnings:		
Balance at beginning of period	51,502	77,584
Net income	29,548	12,582
Cash dividends declared on common stock	(4,475)	(2,644)
Cash dividends declared on preferred stock	(2,401)	(2,934)

Transfer to legal surplus	(3,083)	(1,376)
Balance at end of period	**71,091**	**83,212**
Treasury stock:		
Balance at beginning of period	(16,732)	(17,142)
Stock purchased under the repurchase program	(29,242)	
Exercised restricted stock units with treasury shares	561	
Stock used to match defined contribution plan	27	22
Balance at end of period	**(45,386)**	**(17,120)**
Accumulated other comprehensive income (loss), net of tax:		
Balance at beginning of period	36,987	(82,739)
Other comprehensive income (loss), net of tax	(2,113)	108,101
Balance at end of period	**34,874**	**25,362**
Total stockholders equity	**$ 724,357**	**$ 729,339**

See notes to unaudited consolidated financial statements.

5

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Six-Month Period Ended June 30,	
	2011	2010
	(In thousands)	
Cash flows from operating activities:		
Net income	$ 29,548	$ 12,582
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of deferred loan origination fees, net of costs	(27)	346
Amortization of premiums, net of accretion of discounts	6,186	13,426
Amortization of core deposit intangible	71	23
Accretion of FDIC loss-share indemnification asset, net	(2,231)	(1,314)
Other-than-temporary impairments on securities		2,428
Depreciation and amortization of premises and equipment	2,748	2,596
Deferred income taxes, net	(2,753)	(4,099)
Provision for loan and lease losses, net	8,149	8,114
Stock-based compensation	682	546
Fair value adjustment of servicing asset	(483)	(975)
(Gain) loss on:		
Sale of securities	(9,130)	(23,853)
Sale of mortgage loans held for sale	(2,441)	(2,104)
Derivative activities	7,571	37,251
Sale of foreclosed real estate	135	143
Sale of premises and equipment	38	1,865
Originations and purchases of loans held-for-sale	(106,955)	(106,289)
Proceeds from sale of loans held-for-sale	36,608	35,451
Net (increase) decrease in:		
Trading securities	466	467
Accrued interest receivable	2,286	(977)
Other assets	1,111	(6,706)
Net increase (decrease) in:		
Accrued interest payable on deposits and borrowings	(618)	1,553
Accrued expenses and other liabilities	(22,062)	2,833
Net cash used in operating activities	**(51,101)**	**(26,693)**

See notes to unaudited consolidated financial statements.

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Six-Month Period Ended June 30,	
	2011	**2010**
	(In thousands)	
Cash flows from investing activities:		
Purchases of:		
Investment securities available-for-sale	(492,533)	(3,932,574)
Investment securities held-to-maturity	(209,112)	
FHLB stock	(1,283)	(2,560)
Equity options	(370)	(1,110)
Maturities and redemptions of:		
Investment securities available-for-sale	446,958	1,257,926
Investment securities held-to-maturity	33,412	
FHLB stock		10,077
Proceeds from sales of:		
Investment securities available-for-sale	252,836	2,466,565
Foreclosed real estate	5,806	2,481
Other repossessed assets	2,842	
Premises and equipment	11	635
Origination and purchase of loans, excluding loans held-for-sale	(87,675)	(61,155)
Principal repayment of loans, including covered loans	133,000	84,275
Reimbursements from the FDIC on shared loss agreements	39,870	
Additions to premises and equipment	(2,474)	(934)
Cash and cash equivalents received in FDIC-assisted acquisition		89,777
Net cash provided by (used in) investing activities	**121,288**	**(86,597)**
Cash flows from financing activities:		
Net increase (decrease) in:		
Deposits	(204,576)	65,050
Short term borrowings	(10,658)	(3,979)
Securities sold under agreements ro repurchase	2,600	
Proceeds from:		
Exercise of stock options		21
Issuance of common stock, net		94,390
Issuance of preferred stock, net		189,089
Repayments and advances from purchase money note issued to the FDIC		(5,433)
Purchase of treasury stock	(29,242)	
Termination of derivative instruments	10,648	(25,109)
Dividends paid on preferred stock	(2,401)	(2,934)
Dividends paid on common stock	(4,475)	(2,294)
Net cash provided by (used in) financing activities	**(238,104)**	**308,801**
Net change in cash and cash equivalents	**(167,917)**	**195,511**

Cash and cash equivalents at beginning of period		448,946		277,123
Cash and cash equivalents at end of period	**$**	**281,029**	**$**	**472,634**

See notes to unaudited consolidated financial statements.

Table of Contents

ORIENTAL FINANCIAL GROUP INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2011 AND 2010

	Six-Month Period Ended June 30,			
		2011		2010
	(In thousands)			
Supplemental Cash Flow Disclosure and Schedule of Non-cash Activities:				
Interest paid	$	80,854	$	82,160
Income taxes paid	$	3,848	$	6,281
Mortgage loans securitized into mortgage-backed securities	$	71,007	$	68,155
Securities sold but not yet delivered	$		$	1,490
Securities purchased but not yet received	$		$	533
Transfer from loans to foreclosed real estate and other repossed assets	$	10,464	$	7,522

For the six-month period ended June 30, 2010, the changes in operating assets and liabilities included in the reconciliation of net income to net cash provided by operating activities, as well as the changes in assets and liabilities presented in the investing and financing sections are net of the effect of the assets acquired and liabilities assumed from the Eurobank FDIC-assisted acquisition. Refer to Note 2 to the consolidated financial statements for the composition and balances of the assets and liabilities recorded at fair value by the Group on April 30, 2010. The cash received in the transaction, which amounted to $89.8 million, is presented in the investing activities section of the Consolidated Statements of Cash Flows as Cash and cash equivalents received in FDIC-assisted acquisition .

See notes to unaudited consolidated financial statements.

8

Table of Contents

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 (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, 2011 and 2010 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, 2010, included in the Group s 2010 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 its 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, 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 examination, regulation and periodic reporting under the U.S. Bank Holding Company Act of 1956, as amended, which is administered by the Board of Governors of the Federal Reserve System.

The Bank operates through 30 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 (OCFI) and the Federal Deposit Insurance Corporation (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, operates as an international banking entity (IBE) pursuant to the International Banking Center Regulatory Act of Puerto Rico, as amended. OIB offers the Bank certain Puerto Rico tax advantages. OIB activities are limited under Puerto Rico law to persons and assets/liabilities located outside of Puerto Rico.

Oriental Financial Services is subject to the supervision, examination and regulation of the Financial Industry Regulatory Authority (FINRA), the SEC, and the OCFI. Oriental Insurance 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 consist of the origination and purchase of residential mortgage loans for the Bank s own portfolio and, if the conditions so warrant, the Bank engages in the sale of such loans to other financial institutions in the secondary market. 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 standard Federal National Mortgage Association (the FNMA) or the 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, but has a subservicing arrangement with a third party.

Table of Contents

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 .

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.

Loans and Allowance for Loan and Lease Losses

Because of the loss protection provided by the FDIC, the risks of the FDIC-assisted transaction acquired loans are significantly different from those loans not covered under the FDIC loss sharing agreements. Accordingly, the Group presents loans subject to the loss sharing agreements as covered loans and loans that are not subject to the FDIC loss sharing agreements as non-covered loans . Non-covered loans include any loans made outside of the FDIC shared-loss agreements before or after the April 30, 2010 FDIC-assisted acquisition. Non-covered loans also 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 pay-off are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for non-covered loan and lease losses, unamortized discount related to mortgage servicing right sold and 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 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 to be 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 is less than originally estimated, additional provisions for loan and lease losses are recognized.

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.

Up to March 31, 2011, residential mortgage loans well collateralized and in process of collection, were placed on non-accrual status when reaching 365 days past due. On April 1, 2011, the Bank changed its policy on a prospective basis 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 at the time of changing the policy were also placed on non-accrual status, and the interest receivable on such loans at the time of changing the policy is evaluated at least on a quarterly basis against the collateral underlying the loans, and written-down, if necessary.

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.

Table of Contents

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 and over 90-days past-due. 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 12 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; local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: mortgage loans; commercial loans; consumer loans; and leasing.

Mortgage Loans: These loans are further segregated into four classes: traditional mortgages, non-traditional mortgages, loans in loan modification programs and personal mortgage collateral 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. The personal mortgage collateral loans are mainly equity lines of credit. The allowance factor on these loans is impacted by the historical loss factors on the sub-segments, the environmental risk factors described above and by delinquency buckets.

Commercial loans: These loans consist mainly of commercial loans secured by existing commercial real estate properties. The allowance factor assigned to these loans are 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 or in the form of automobile and equipment loans. 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. This is a new business line introduced in 2010, and as such, the historical loss factor has been matched to consumer loans due to the lack of historical losses on leases.

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 difference. The non-accretable difference 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 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. Decreases in expected cash flows compared to those originally estimated decrease the accretable yield and are recognized by recording a provision for loan and lease losses and establishing an allowance for loan and lease losses.

Loans accounted for under ASC 310-30 are generally considered accruing and performing loans as the loans accrete interest income over the estimated life of the loan when cash flows are reasonably estimable. Accordingly, acquired impaired loans that are contractually past due are still considered to be accruing and performing loans. If the timing and amount of cash flows is not reasonably estimable, the loans may be classified as nonaccrual loans and interest income may be recognized on a cash basis or as a reduction of the principal amount outstanding.

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 the acquired covered loans as of the measurement date compared to those initially estimated 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 and equipment 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.

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.

A financial instrument s level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

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 follows ASC 320-10-65-1, which changed the accounting requirements for other-than-temporary impairments for debt securities, and in certain circumstances, 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 credit loss is recognized in income with the remaining noncredit-related component being 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.

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

identification and evaluation of investments that have indications of possible other-than-temporary impairment;

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 maintains an overall interest rate risk-management strategy that 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 asset 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 US Treasury bonds and notes in the future at specified prices. Interest rate options represent contracts that allow the holder of the option to (1) receive cash or (2) 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.

The Group also offers 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 is 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 the cash or value of the collateral delivered as part of the transactions in as far as it 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 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 and trading strategies.

14

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 new 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 (1) specific assets and liabilities on the balance sheet or (2) 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 no significant ineffectiveness.

The Group discontinues hedge accounting prospectively when (1) 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); (2) the derivative expires or is sold, terminated, or exercised; (3) it is no longer probable that the forecasted transaction will occur; (4) a hedged firm commitment no longer meets the definition of a firm commitment; or (5) management determines that designating the derivative as a hedging instrument is no longer appropriate or desired.

FDIC Shared-Loss Indemnification Asset

The FDIC shared-loss indemnification asset is accounted for as an indemnification asset 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 loss sharing percentages. 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 loss sharing 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 loss sharing 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.

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 intangibles for impairment when an indication of impairment exists. No impairment charges were required to be recorded in the period ended June 30, 2011. If an impairment loss is determined to exist in the future, the loss would be reflected as non-interest expenses in the unaudited consolidated statements of operations for the period in which such impairment is identified.

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 less cost to sell of the real estate 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 were 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 are charged 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.

Income Taxes

In preparing the unaudited 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 unaudited consolidated statements of operations.

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

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 uncertain tax positions accruals are adjusted in light of changing facts and circumstances, such as the progress of tax audits, case law, and emerging legislation. The Group s uncertain tax positions accruals are reflected as income tax payable as a component of accrued expenses and other liabilities. These accruals are reduced upon expiration of 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 of being 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 unaudited consolidated statements of operations.

On January 31, 2011, the Governor of Puerto Rico signed into law the Internal Revenue Code for a New Puerto Rico, which was subsequently amended (the 2011 Code). As such, the Puerto Rico Internal Revenue Code of 1994, as amended, (the 1994 Code) would be gradually repealed by the 2011 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% regular income tax rate but establishes significant lower surtax rates. The 2011 Code provides a surtax rate from 5% to 10% for years starting after December 31, 2010, but before January 1, 2014. That surtax rate may be reduced to 5% after December 31, 2013, 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 net taxable income of each of the entities members of the controlled group reduced by the surtax deduction. The 2011 Code also provides a surtax deduction of $750,000. In the case of controlled group of corporations, the surtax deduction should be distributed among the members of the controlled group. The alternative minimum tax is 20%. The 2011 Code 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. Under the 2011 Code, a corporate taxpayer has an irrevocable one-time election to defer the application of the 2011 Code for five years. 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 and for each of the next four taxable years.

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, if earlier, (b) 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.

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.

Table of Contents

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, 2011 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.

Recent Accounting Developments:

Comprehensive Income FASB Accounting Standards Update (ASU) 2011-05, Comprehensive Income (FASB ASC Subtopic 220) Presentation of Comprehensive Income was issued in June 2011. In this update an entity has the option to present comprehensive income in either one or two consecutive financial statements: (1) a single statement must present each component of net income along with total net income, each component of other comprehensive income along with total other comprehensive income, and a total for comprehensive income, and (2) in a two-statement approach, an entity must present the components of net income and total net income in the first statement, that statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The option in current GAAP that permits the presentation of other comprehensive income in the statement of changes in equity has been eliminated. The amendments in this update should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The Group believes that the implementation of this guidance will not have a material impact in the Group s unaudited consolidated financial statements.

Fair Value Measurements FASB ASU 2011-04, Fair Value Measurement (FASB ASC Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs , issued in May 2011, changes 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. For many of the requirements, the Board does not expect the amendments in this Update to result in a change in the application of the requirements in Topic 820. Some of the amendments clarify the Board s intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. This update is effective for interim and annual reporting periods beginning after December 15, 2011. Early application by public entities is not permitted. The Group believes that the implementation of this guidance will not have a material impact in the Group s unaudited consolidated financial statements.

Transfers and Servicing FASB ASU 2011-03, Transfers and Servicing (FASB ASC Subtopic 860) - Reconsideration of Effective Control for Repurchase Agreements , issued in April 2011, removes from the assessment of effective control (1) 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 (2) the collateral maintenance implementation guidance related to that criterion. This update is 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 is not permitted. The Group believes that the implementation of this guidance will not have a material impact in the Group s unaudited consolidated financial statements.

Troubled Debt Restructuring In April 2011, FASB issued ASU No. 2011-02, A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. ASU No. 2011-02 requires that when evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: a) the restructuring constitutes a concession; b) The debtor is experiencing financial difficulties. Also, the ASU sets the effective date when an entity should disclose the information deferred by ASU No. 2011-01, for interim and annual periods beginning on or after June 15, 2011. The Group is in the process of evaluating the effect this accounting guidance may have on the Group s unaudited consolidated financial statements.

Other accounting standards that have been issued by FASB or other standards-setting bodies are not expected to have a material impact on the Group s financial position, results of operations or cash flows.

18

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 (each, a shared-loss agreement and collectively, the shared-loss agreements), whereby the FDIC will cover a substantial portion of any future 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 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 for loss share on single family residential mortgage loans is ten years with respect to losses and loss recoveries, while the term for loss share on 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 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 Bank and the FDIC had been engaged in ongoing discussions and preliminary settlements that impacted certain assets acquired or certain liabilities assumed by the Bank on April 30, 2010, and that were included as measurement period adjustments in the table below. On April 29, 2011, the Bank and the FDIC reached a final settlement as part of the Purchase and Assumption Agreement. The final settlement did not have a material effect on the Bank s financial statements.

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 of the final shared loss month, or upon the final disposition of all covered assets under the loss sharing agreements in the event losses thereunder fail to reach expected levels. Under the loss sharing 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 loss sharing agreements during which the loss sharing provisions of the applicable loss sharing 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 $11.1 million at June 30, 2011, net. 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 loss sharing agreements between the Bank and the FDIC.

The operating results of the Group for the six-month periods ended June 30, 2011 and 2010 include the operating results produced by the acquired assets and liabilities assumed since May 1, 2010. The Group believes that given the nature of assets and liabilities assumed, the significant amount of fair value adjustments, the nature of additional consideration provided to the FDIC (note payable and equity appreciation instrument) and the FDIC loss sharing agreements now in place, historical results of Eurobank are not meaningful to the Group s results, and thus no pro forma information is presented.

Net-assets acquired and the respective measurement period adjustments are reflected in the table below:

	Book value April 30, 2010	Fair Value Adjustments	April 30, 2010 (As initially reported)	Measurement Period Adjustments	April 30 ,2010 (As remeasured)
			(in thousands)		
Assets					
Cash and cash equivalents	$ 89,777	$	$ 89,777	$	$ 89,777
Federal Home Loan Bank (FHLB) stock	10,077		10,077		10,077
Loans covered under shared-loss agreements with the FDIC	1,536,416	(699,942)	836,474	(53,568)	782,906
Loans not covered under shared-loss agreements with the FDIC	4,275	(1,266)	3,009	7	3,016
Foreclosed real estate covered under shared-loss agreements with the FDIC	26,082	(8,555)	17,527	(4,032)	13,495
Other repossessed assets covered under shared-loss agreements with the FDIC	3,401	(339)	3,062		3,062
FDIC shared-loss indemnification asset		516,250	516,250	28,961	545,211
Core deposit intangible		1,423	1,423		1,423
Deferred tax asset, net				1,441	1,441
Goodwill				365	365
Other assets	20,168	(14,867)	5,301	1,279	6,580
Total assets acquired	$ 1,690,196	$ (207,296)	$ 1,482,900	$ (25,547)	