

ORIENTAL FINANCIAL GROUP INC  
Form 10-Q  
November 09, 2012

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 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 x No

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

45,577,920 common shares (\$1.00 par value per share) outstanding as of October 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. (“we”, “our” or 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 expressions 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”);
- the Group’s ability to successfully deleverage the investment securities and wholesale funding portfolios of the Group and Banco Bilbao Vizcaya Argentaria Puerto Rico in connection with the acquisition of BBVA’s Puerto Rico operations; 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

SEPTEMBER 30, 2012 AND DECEMBER 31, 2011

|   | September 30,<br>2012             | December 31,<br>2011 |
|---|-----------------------------------|----------------------|
|   | (In thousands, except share data) |                      |
| <b>ASSETS</b>   |                                   |                      |
| <b>Cash and cash equivalents</b>  |                                   |                      |
| Cash and due from banks   | \$ 511,478                        | \$ 587,624           |
| Money market investments  | 4,017                             | 3,863                |
| <b>Total cash and cash equivalents</b>  | <b>515,495</b>                    | <b>591,487</b>       |
| <b>Securities purchased under agreements to resell</b>  | <b>270,000</b>                    | <b>-</b>             |
| <b>Investments:</b>   |                                   |                      |
| Trading securities, at fair value, with amortized cost of \$1,503 (December 31, 2011 - \$176)   | 1,514                             | 180                  |
| Investment securities available-for-sale, at fair value, with amortized cost of \$2,228,629 (December 31, 2011 - \$2,873,682)                       | 2,293,550                         | 2,959,912            |
| Investment securities held-to-maturity, at amortized cost, with fair value of \$874,921 (December 31, 2011 - \$904,556)                             | 835,084                           | 884,026              |
| Federal Home Loan Bank (FHLB) stock, at cost  | 22,865                            | 23,779               |
| Other investments   | 69                                | 73                   |
| <b>Total investments</b>  | <b>3,153,082</b>                  | <b>3,867,970</b>     |
| <b>Loans:</b>   |                                   |                      |
| Mortgage loans held-for-sale, at lower of cost or fair value  | 38,211                            | 26,939               |
| Loans not covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of \$39,120 (December 31, 2011 - \$37,010) | 1,144,519                         | 1,142,978            |
| Loans covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of \$56,865 (December 31, 2011 - \$37,256)     | 413,588                           | 496,276              |
| <b>Total loans, net</b>   | <b>1,596,318</b>                  | <b>1,666,193</b>     |
| FDIC shared-loss indemnification asset  | 328,573                           | 392,367              |
| Foreclosed real estate covered under shared-loss agreements with the FDIC   | 21,635                            | 13,867               |
| Foreclosed real estate not covered under shared-loss agreements with the FDIC   | 17,765                            | 13,812               |
| Accrued interest receivable   | 14,935                            | 20,182               |
| Deferred tax asset, net   | 35,912                            | 32,023               |
| Premises and equipment, net   | 19,268                            | 21,520               |
| Servicing assets  | 10,642                            | 10,454               |
| Derivative assets   | 18,495                            | 9,317                |

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|   |    |                  |    |                  |
|---|----|------------------|----|------------------|
| Other assets  |    | 49,085           |    | 54,483           |
| <b>Total assets</b>   | \$ | <b>6,051,205</b> | \$ | <b>6,693,675</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |    |                  |    |                  |
| <b>Deposits:</b>  |    |                  |    |                  |
| Demand deposits   | \$ | 1,048,410        | \$ | 1,043,031        |
| Savings accounts  |    | 250,952          |    | 230,672          |
| Certificates of deposit   |    | 915,005          |    | 1,161,482        |
| <b>Total deposits</b>   |    | <b>2,214,367</b> |    | <b>2,435,185</b> |
| <b>Borrowings:</b>  |    |                  |    |                  |
| Securities sold under agreements to repurchase  |    | 2,652,366        |    | 3,056,238        |
| Advances from FHLB  |    | 285,395          |    | 281,753          |
| FDIC-guaranteed term notes  |    | -                |    | 105,834          |
| Subordinated capital notes  |    | 36,083           |    | 36,083           |
| <b>Total borrowings</b>   |    | <b>2,973,844</b> |    | <b>3,479,908</b> |
| Derivative liabilities  |    | 58,269           |    | 47,425           |
| Accrued expenses and other liabilities  |    | 33,038           |    | 35,602           |
| <b>Total liabilities</b>  |    | <b>5,279,518</b> |    | <b>5,998,120</b> |
| <b>Stockholders' equity:</b>  |    |                  |    |                  |
| Preferred stock; 10,000,000 shares authorized;<br>1,340,000 shares of Series A and 1,380,000<br>shares of Series B issued and outstanding, \$25<br>liquidation value      |    | 68,000           |    | 68,000           |
| 84,000 shares of Series C issued and<br>outstanding; \$1,000 liquidation value  |    | 84,000           |    | -                |
| Common stock, \$1 par value; 100,000,000 shares<br>authorized; 47,841,611 shares issued;<br>40,745,946 shares outstanding (December 31,<br>2011 - 47,808,657; 41,244,533) |    | 47,842           |    | 47,809           |
| Additional paid-in capital  |    | 495,155          |    | 499,096          |
| Legal surplus   |    | 54,407           |    | 50,178           |
| Retained earnings   |    | 94,520           |    | 68,149           |
| Treasury stock, at cost, 7,095,665 shares<br>(December 31, 2011 - 6,564,124 shares)   |    | (81,300)         |    | (74,808)         |
| Accumulated other comprehensive income, net of<br>tax of -\$2,411 (December 31, 2011 - \$1,848)   |    | 9,063            |    | 37,131           |
| <b>Total stockholders' equity</b>   |    | <b>771,687</b>   |    | <b>695,555</b>   |
| <b>Total liabilities and stockholders' equity</b>   | \$ | <b>6,051,205</b> | \$ | <b>6,693,675</b> |

See notes to unaudited consolidated financial statements

## ORIENTAL FINANCIAL GROUP INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE QUARTERS AND NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

|  | Quarter Ended September 30,           |               | Nine-Month Period Ended |                       |
|--|---------------------------------------|---------------|-------------------------|-----------------------|
|  | 2012                                  | 2011          | 2012                    | September 30,<br>2011 |
|  | (In thousands, except per share data) |               |                         |                       |
| <b>Interest income:</b>  |                                       |               |                         |                       |
| Loans not covered under shared-loss agreements with the FDIC         | 17,964                                | \$ 17,161     | \$ 53,308               | \$ 51,095             |
| Loans covered under shared-loss agreements with the FDIC             | 22,283                                | 18,222        | 64,167                  | 45,507                |
| <b>Total interest income from loans</b>                              | <b>40,247</b>                         | <b>35,383</b> | <b>117,475</b>          | <b>96,602</b>         |
| Mortgage-backed securities   | 24,310                                | 33,515        | 74,647                  | 128,275               |
| Investment securities and other                                      | 1,129                                 | 2,638         | 4,271                   | 6,895                 |
| <b>Total interest income</b>   | <b>65,686</b>                         | <b>71,536</b> | <b>196,393</b>          | <b>231,772</b>        |
| <b>Interest expense:</b>   |                                       |               |                         |                       |
| Deposits   | 7,308                                 | 11,492        | 24,518                  | 35,321                |
| Securities sold under agreements to repurchase                       | 15,344                                | 23,206        | 49,414                  | 70,878                |
| Advances from FHLB and other borrowings                              | 2,508                                 | 3,042         | 8,438                   | 9,036                 |
| FDIC-guaranteed term notes   | -                                     | 1,021         | 909                     | 3,063                 |
| Subordinated capital notes   | 323                                   | 305           | 972                     | 916                   |
| <b>Total interest expense</b>  | <b>25,483</b>                         | <b>39,066</b> | <b>84,251</b>           | <b>119,214</b>        |
| <b>Net interest income</b>   | <b>40,203</b>                         | <b>32,470</b> | <b>112,142</b>          | <b>112,558</b>        |
| Provision for non-covered loan and lease losses                      | 3,600                                 | 3,800         | 10,400                  | 11,400                |
| Provision for (recapture of) covered loan and lease losses, net      | 221                                   | (1,936)       | 8,845                   | (1,387)               |
| <b>Total provision for loan and lease losses</b>                     | <b>3,821</b>                          | <b>1,864</b>  | <b>19,245</b>           | <b>10,013</b>         |
| <b>Net interest income after provision for loan and lease losses</b> | <b>36,382</b>                         | <b>30,606</b> | <b>92,897</b>           | <b>102,545</b>        |
| <b>Non-interest income:</b>  |                                       |               |                         |                       |
| Wealth management revenues   | 6,042                                 | 5,387         | 17,835                  | 14,644                |
| Banking service revenues   | 3,006                                 | 2,969         | 9,231                   | 9,496                 |
| Mortgage banking activities  | 2,204                                 | 2,758         | 7,142                   | 7,017                 |
| <b>Total banking and wealth management revenues</b>                  | <b>11,252</b>                         | <b>11,114</b> | <b>34,208</b>           | <b>31,157</b>         |
| Net amortization of FDIC shared-loss indemnification asset           | (8,096)                               | (2,422)       | (18,505)                | (191)                 |
| Net gain (loss) on:  |                                       |               |                         |                       |
| Sale of securities   | 36,365                                | 13,971        | 55,703                  | 23,102                |
| Derivatives  | (1,326)                               | (695)         | (1,441)                 | (8,392)               |
| Foreclosed real estate   | (1,209)                               | (199)         | (2,493)                 | (334)                 |

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|  |                  |                  |                  |                  |
|--|------------------|------------------|------------------|------------------|
| Early extinguishment of repurchase agreements              | (24,312)         | (4,790)          | (24,312)         | (4,790)          |
| Other  | 978              | (14)             | 208              | 148              |
| <b>Total non-interest income, net</b>                      | <b>13,652</b>    | <b>16,965</b>    | <b>43,368</b>    | <b>40,700</b>    |
| <b>Non-interest expense:</b>                               |                  |                  |                  |                  |
| Compensation and employee benefits                         | 11,323           | 11,593           | 32,873           | 34,511           |
| Professional and service fees                              | 5,779            | 5,308            | 16,221           | 16,506           |
| Occupancy and equipment                                    | 4,169            | 4,369            | 12,624           | 12,988           |
| Insurance  | 1,594            | 1,302            | 4,856            | 4,933            |
| Electronic banking charges                                 | 1,415            | 1,375            | 4,581            | 3,984            |
| Taxes, other than payroll and income taxes                 | 1,091            | 1,184            | 2,158            | 3,422            |
| Loan servicing and clearing expenses                       | 607              | 975              | 2,530            | 3,072            |
| Foreclosure, repossession and other real estate expenses   | 1,060            | 606              | 2,745            | 1,659            |
| Advertising, business promotion, and strategic initiatives | 1,594            | 1,686            | 4,006            | 4,386            |
| Communication  | 419              | 391              | 1,246            | 1,212            |
| Director and investor relations                            | 158              | 352              | 809              | 977              |
| Printing, postage, stationary and supplies                 | 299              | 292              | 929              | 937              |
| Other  | 871              | 770              | 2,428            | 2,661            |
| <b>Total non-interest expense</b>                          | <b>30,379</b>    | <b>30,203</b>    | <b>88,006</b>    | <b>91,248</b>    |
| <b>Income before income taxes</b>                          | <b>19,655</b>    | <b>17,368</b>    | <b>48,259</b>    | <b>51,997</b>    |
| Income tax expense   | 1,894            | 580              | 4,888            | 5,661            |
| <b>Net income</b>  | <b>17,761</b>    | <b>16,788</b>    | <b>43,371</b>    | <b>46,336</b>    |
| Less: dividends on preferred stock                         | (3,039)          | (1,201)          | (5,440)          | (3,602)          |
| <b>Income available to common shareholders</b>             | <b>\$ 14,722</b> | <b>\$ 15,587</b> | <b>\$ 37,931</b> | <b>\$ 42,734</b> |
| <b>Income per common share:</b>                            |                  |                  |                  |                  |
| Basic  | \$ 0.36          | \$ 0.35          | \$ 0.93          | \$ 0.95          |
| Diluted  | \$ 0.35          | \$ 0.35          | \$ 0.92          | \$ 0.95          |
| <b>Average common shares outstanding and equivalents</b>   | <b>47,978</b>    | <b>44,105</b>    | <b>43,316</b>    | <b>45,141</b>    |
| <b>Cash dividends per share of common stock</b>            | <b>\$ 0.06</b>   | <b>\$ 0.05</b>   | <b>\$ 0.18</b>   | <b>\$ 0.15</b>   |

See notes to unaudited consolidated financial statements

## ORIENTAL FINANCIAL GROUP INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

## FOR THE QUARTERS AND NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

|   | Quarter Ended September 30, |                 | Nine-Month Period Ended<br>September 30, |                  |
|---|-----------------------------|-----------------|--|------------------|
|   | 2012                        | 2011            | 2012                                     | 2011             |
|   | (In thousands)              |                 | (In thousands)                           |                  |
| <b>Net income</b>   | \$ 17,761                   | \$ 16,788       | \$ 43,371                                | \$ 46,336        |
| <b>Other comprehensive loss before tax:</b>                   |                             |                 |  |                  |
| Unrealized gain on securities available-for-sale              | 25,220                      | 35,471          | 34,220                                   | 57,098           |
| Realized gain on investment securities included in net income | (36,365)                    | (13,971)        | (55,703)                                 | (23,102)         |
| Unrealized loss on cash flow hedges                           | (2,052)                     | (34,204)        | (10,844)                                 | (48,122)         |
| <b>Other comprehensive loss before taxes</b>                  | <b>(13,197)</b>             | <b>(12,704)</b> | <b>(32,327)</b>                          | <b>(14,126)</b>  |
| Income tax effect   | 999                         | 2,550           | 4,259                                    | 1,858            |
| <b>Other comprehensive loss after taxes</b>                   | <b>(12,198)</b>             | <b>(10,154)</b> | <b>(28,068)</b>                          | <b>(12,268)</b>  |
| <b>Comprehensive income</b>                                   | \$ <b>5,563</b>             | \$ <b>6,634</b> | \$ <b>15,303</b>                         | \$ <b>34,068</b> |

See notes to unaudited consolidated financial statements

## ORIENTAL FINANCIAL GROUP INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

FOR THE NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

|  | Nine-Month Period Ended September 30, |                   |
|--|---------------------------------------|-------------------|
|  | 2012                                  | 2011              |
|  | (In thousands)                        |                   |
| <b>Preferred stock:</b>                                    |                                       |                   |
| Balance at beginning of period                             | \$ 68,000                             | \$ 68,000         |
| Issuance of preferred stock                                | 84,000                                | -                 |
| <b>Balance at end of period</b>                            | <b>152,000</b>                        | <b>68,000</b>     |
| <b>Common stock:</b>                                       |                                       |                   |
| Balance at beginning of period                             | 47,809                                | 47,808            |
| Exercised stock options                                    | 33                                    | -                 |
| <b>Balance at end of period</b>                            | <b>47,842</b>                         | <b>47,808</b>     |
| <b>Additional paid-in capital:</b>                         |                                       |                   |
| Balance at beginning of period                             | 499,096                               | 498,435           |
| Stock-based compensation expense                           | 1,159                                 | 1,001             |
| Exercised stock options                                    | 361                                   | -                 |
| Lapsed restricted stock units                              | (483)                                 | (561)             |
| Preferred stock issuance costs                             | (4,978)                               | -                 |
| <b>Balance at end of period</b>                            | <b>495,155</b>                        | <b>498,875</b>    |
| <b>Legal surplus:</b>                                      |                                       |                   |
| Balance at beginning of period                             | 50,178                                | 46,331            |
| Transfer from retained earnings                            | 4,229                                 | 4,943             |
| <b>Balance at end of period</b>                            | <b>54,407</b>                         | <b>51,274</b>     |
| <b>Retained earnings:</b>                                  |                                       |                   |
| Balance at beginning of period                             | 68,149                                | 51,502            |
| Net income   | 43,371                                | 46,336            |
| Cash dividends declared on common stock                    | (7,331)                               | (6,677)           |
| Cash dividends declared on preferred stock                 | (5,440)                               | (3,602)           |
| Transfer to legal surplus                                  | (4,229)                               | (4,943)           |
| <b>Balance at end of period</b>                            | <b>94,520</b>                         | <b>82,616</b>     |
| <b>Treasury stock:</b>                                     |                                       |                   |
| Balance at beginning of period                             | (74,808)                              | (16,732)          |
| Stock purchased  | (7,022)                               | (29,242)          |
| Lapsed restricted stock units                              | 483                                   | 561               |
| Stock used to match defined contribution plan              | 47                                    | 37                |
| <b>Balance at end of period</b>                            | <b>(81,300)</b>                       | <b>(45,376)</b>   |
| <b>Accumulated other comprehensive income, net of tax:</b> |                                       |                   |
| Balance at beginning of period                             | 37,131                                | 36,987            |
| Other comprehensive loss, net of tax                       | (28,068)                              | (12,268)          |
| <b>Balance at end of period</b>                            | <b>9,063</b>                          | <b>24,719</b>     |
| <b>Total stockholders' equity</b>                          | <b>\$ 771,687</b>                     | <b>\$ 727,916</b> |

See notes to unaudited consolidated financial statements



## ORIENTAL FINANCIAL GROUP INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

Nine-Month Period Ended September 30,  
2012 2011

(In thousands)

**Cash flows from operating activities:**

|   |    |               |    |                 |
|---|----|---------------|----|-----------------|
| Net income  | \$ | 43,371        | \$ | 46,336          |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |    |               |    |                 |
| Amortization of deferred loan origination fees, net of costs                                |    | 462           |    | (151)           |
| Amortization of investment securities premiums, net of accretion of discounts               |    | 33,480        |    | 18,983          |
| Amortization of core deposit intangible   |    | 107           |    | 107             |
| Net amortization of FDIC shared-loss indemnification asset                                  |    | 18,505        |    | 191             |
| Other impairments on securities   |    | -             |    | 75              |
| Depreciation and amortization of premises and equipment                                     |    | 3,424         |    | 4,109           |
| Deferred income taxes, net  |    | (785)         |    | 4,485           |
| Provision for covered and non-covered loan and lease losses, net                            |    | 19,245        |    | 10,013          |
| Stock-based compensation  |    | 1,159         |    | 1,001           |
| (Gain) loss on:   |    |               |    |                 |
| Sale of securities  |    | (55,703)      |    | (23,102)        |
| Sale of mortgage loans held for sale  |    | (4,658)       |    | (3,971)         |
| Derivatives   |    | 1,441         |    | 8,392           |
| Early extinguishment of repurchase agreements   |    | 24,312        |    | 4,790           |
| Foreclosed real estate  |    | 2,493         |    | 334             |
| Sale of other repossessed assets  |    | (8)           |    | 34              |
| Sale of premises and equipment  |    | (85)          |    | 31              |
| Originations and purchases of loans held-for-sale   |    | (140,925)     |    | (149,990)       |
| Proceeds from sale of loans held-for-sale   |    | 74,815        |    | 55,243          |
| Net (increase) decrease in:   |    |               |    |                 |
| Trading securities  |    | (1,334)       |    | 984             |
| Accrued interest receivable   |    | 5,247         |    | 4,470           |
| Servicing assets  |    | (188)         |    | (319)           |
| Other assets  |    | 5,080         |    | 4,708           |
| Net decrease in:  |    |               |    |                 |
| Accrued interest on deposits and borrowings   |    | (8,227)       |    | (1,097)         |
| Accrued expenses and other liabilities  |    | (8,578)       |    | (31,378)        |
| <b>Net cash provided by (used in) operating activities</b>                                  |    | <b>12,650</b> |    | <b>(45,722)</b> |



**Cash flows from investing activities:**

|  |                |                |
|--|----------------|----------------|
| Purchases of:  |                |                |
| Investment securities available-for-sale                         | (1,102,606)    | (493,757)      |
| Investment securities held-to-maturity                           | (119,026)      | (209,112)      |
| FHLB stock   | (454)          | (1,283)        |
| Swap options   | (6,755)        | -              |
| Equity options   | -              | (424)          |
| Maturities and redemptions of:                                   |                |                |
| Investment securities available-for-sale                         | 691,246        | 606,699        |
| Investment securities held-to-maturity                           | 160,502        | 57,509         |
| FHLB stock   | 1,368          | -              |
| Proceeds from sales of:  |                |                |
| Investment securities available-for-sale                         | 1,145,555      | 506,481        |
| Foreclosed real estate   | 11,093         | 8,875          |
| Other repossessed assets   | 2,500          | 4,883          |
| Premises and equipment   | 369            | 287            |
| Origination and purchase of loans, excluding loans held-for-sale | (172,376)      | (138,692)      |
| Principal repayment of loans, including covered loans            | 195,336        | 204,537        |
| Reimbursements from the FDIC on shared-loss agreements           | 63,272         | 73,267         |
| Additions to premises and equipment                              | (1,457)        | (2,984)        |
| Net change in securities purchased under agreements to resell    | (270,000)      | (165,000)      |
| <b>Net cash provided by investing activities</b>                 | <b>598,567</b> | <b>451,286</b> |

See notes to unaudited consolidated financial statements

## ORIENTAL FINANCIAL GROUP INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)

## FOR THE NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

|   | Nine-Month Period Ended September 30, |                   |
|---|---------------------------------------|-------------------|
|   | 2012                                  | 2011              |
|   | (In thousands)                        |                   |
| <b>Cash flows from financing activities:</b>                                  |                                       |                   |
| Net increase (decrease) in:   |                                       |                   |
| Deposits  | (222,408)                             | (207,107)         |
| Short term borrowings   | -                                     | 4,159             |
| Securities sold under agreements to repurchase                                | (424,312)                             | (104,790)         |
| FHLB advances   | 5,013                                 | -                 |
| FDIC-guaranteed term notes  | (105,000)                             | -                 |
| Exercise of stock options   | 394                                   | -                 |
| Issuance of preferred stock, net  | 79,022                                | -                 |
| Purchase of treasury stock  | (7,022)                               | (29,242)          |
| Termination of derivative instruments   | (125)                                 | 10,095            |
| Dividends paid on preferred stock   | (5,440)                               | (3,602)           |
| Dividends paid on common stock  | (7,331)                               | (6,677)           |
| <b>Net cash used in financing activities</b>                                  | <b>(687,209)</b>                      | <b>(337,164)</b>  |
| <b>Net change in cash and cash equivalents</b>                                | <b>(75,992)</b>                       | <b>68,400</b>     |
| Cash and cash equivalents at beginning of period                              | 591,487                               | 448,936           |
| Cash and cash equivalents at end of period                                    | <b>\$ 515,495</b>                     | <b>\$ 517,336</b> |
| <b>Supplemental Cash Flow Disclosure and Schedule of Non-cash Activities:</b> |                                       |                   |
| Interest paid   | \$ 91,823                             | \$ 120,544        |
| Income taxes paid   | \$ 8,031                              | \$ 4,021          |
| Mortgage loans securitized into mortgage-backed securities                    | \$ 59,629                             | \$ 104,617        |
| Transfer from loans to foreclosed real estate                                 | \$ 27,583                             | \$ 17,754         |

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 September 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 operating subsidiaries, Oriental Bank and Trust (the “Bank” or “Oriental Bank”), Oriental Financial Services Corp. (“Oriental Financial Services”), Oriental Insurance, Inc. (“Oriental Insurance”) and Caribbean Pension Consultants, Inc. (“CPC”). 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 commercial, consumer and mortgage 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, except for CPC, which is located in Boca Raton, Florida. The Group is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (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 Financial Services is also a member of the Securities Investor Protection Corporation. 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)**

***Business Combinations***

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 (i) BBVAPR Holding Corporation (“BBVAPR Holding”), the sole shareholder of Banco Bilbao Vizcaya Argentaria Puerto Rico (“BBVAPR Bank”), a Puerto Rico chartered commercial bank, and BBVA Seguros, Inc. (“BBVA Seguros”), a subsidiary offering insurance services, and (ii) BBVA Securities of Puerto Rico, Inc. (“BBVA Securities”), a registered broker-dealer. This transaction is referred to as the “BBVAPR Acquisition” and BBVAPR Holding, BBVAPR Bank, BBVA Seguros and BBVA Securities are collectively referred to as the “BBVAPR Companies.”

The Group will acquire all of the outstanding common stock of each of BBVAPR Holding and BBVA Securities with total assets at June 30, 2012 amounting to \$5.0 billion, including \$3.6 billion in loans (net of allowance for loan and lease losses), and \$3.4 billion in deposits for an aggregate purchase price of \$500 million. Immediately following the closing of the BBVAPR Acquisition, the Group will merge BBVAPR Bank with and into Oriental Bank, with Oriental Bank continuing as the surviving entity. The unaudited consolidated financial statements do not contemplate the effect of the BBVAPR Acquisition as the transaction has not been consummated at September 30, 2012.

Closing of the transaction is targeted for the fourth quarter of 2012. Consummation of the BBVAPR 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. On October 10, 2012, the OCFI approved the Group’s acquisition of BBVAPR Bank and the merger of BBVAPR Bank with and into Oriental Bank, with Oriental Bank as the surviving entity.

Under the Acquisition Agreement, the Group may be subject to a reverse break-up fee of \$25 million if the closing of the BBVAPR Acquisition 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), the Acquisition Agreement is terminated, and the failure to close within one year (or such later date) is due to our inability to raise the specified additional funds or to obtain certain regulatory approvals or any other reason other than certain breaches by BBVA, subject to certain conditions. In addition, BBVA could seek damages in excess of \$25 million if BBVA terminates the Acquisition Agreement due to our failure to satisfy the funding requirement or if our willful and knowing breach of

the Acquisition Agreement is the proximate cause of the BBVAPR Acquisition not having been consummated, and BBVA suffers losses as a result in excess of the \$25 million termination fee. If BBVA decides to terminate the Acquisition Agreement and collect the termination fee, such additional damages would be limited to BBVA's losses in excess of the termination fee, and could not exceed an additional \$25 million. Such limit would not apply if BBVA does not elect to terminate the Acquisition Agreement and collect the termination fee.

In connection with the BBVAPR Acquisition, the Group has completed the sale of:

- (i) 84,000 shares of its 8.750% Non-Cumulative Convertible Perpetual Preferred Stock, Series C (the "Convertible Preferred Stock"), on July, 3, 2012 at a purchase price of \$1,000 per share in a private placement;
- (ii) 4,829,267 shares of its common stock on October 31, 2012 at a public offering price of \$11.10 and a purchase price of \$10.66 per share in a registered public offering; and
- (iii) 960,000 shares of its 7.125% Non-Cumulative Perpetual Preferred Stock, Series D (the "Series D Preferred Stock") on November 5, 2012 at a public offering price of \$25 and purchase price of \$24 per share in a registered public offering.

The Group intends to use the net proceeds of the foregoing issuances together with its own excess capital to fund the BBVAPR Acquisition.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

*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 (“FASB”) 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.

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 that 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 gains and losses 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. During the quarter ended September 30, 2012, the Group made a change in one of the estimates applied in the calculation of the amortization of premiums/discounts in the mortgage-backed securities portfolio. The estimate involves the period used in measuring the repayment experience of each security and the change consists of using a 12-month look-back period instead of a 3-month period for these purposes. The Group believes that this extended period better reflects the portfolio behavior, especially considering the seasonality cycle of the U.S. housing market, and also reduces the volatility that affects interest income recognition when using a more limited prepayment history experience in periods of greater market volatility. The impact of this change during the quarter ended September 30, 2012 was an increase of \$3.3 million in interest income from mortgage-backed securities.

### ***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.



**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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.

***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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

*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.

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 ("S&P 500 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 S&P 500 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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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 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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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 collateral value. Additional impact from the historical loss experience is applied based on levels of delinquency and loan classification. During the quarter ended September 30, 2012, the Group revised this severity impact applied to historical loss factors based on delinquency buckets and loan classifications to further segregate these impacts between loans secured by real estate and unsecured loans. 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 a 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. During the second quarter of 2012, 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.



**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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, 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 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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

***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.

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 nine 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.

***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, the proper submission of claims to the FDIC and compliance with the obligations set forth in the FDIC shared-loss agreements. 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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

***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 nine-month periods ended September 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 expense. 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 with 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 expense 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 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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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 processes, 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 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 is currently fully exempt, but was subject to a 5% income tax for the 2009, 2010 and 2011 taxable years. Under the 2011 Code, a corporate taxpayer had a one-time option of determining its income tax liability and filing its income tax return pursuant to the 1994 Code. This election was required with the filing of the 2011 income tax return and, once made, was irrevocable for such taxable year and for each of the next four taxable years. The Group elected to implement and file its income tax returns pursuant to 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 2007 Omnibus Performance Incentive Plan, as amended and restated (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.



**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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 September 30, 2012, and has adjusted and disclosed those events that have occurred that would require adjustment or disclosure in the unaudited consolidated financial statements.

Refer to Note 1 *Business Combinations* section for details of preferred stock and common stock issued after September 30, 2012 in connection to the prospective BBVAPR Acquisition.

***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”) 2011-12, “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.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

**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.

**Intangibles—Goodwill and Other** – FASB ASU 2012-02, “Testing Indefinite-Lived Intangible Assets for Impairment (Topic 350) was issued in July 2012. This update establish that an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying. An entity also has the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012.

**ORIENTAL FINANCIAL GROUP INC.**

**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 in the FDIC-assisted acquisition of Eurobank. 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 \$14.8 million and \$13.3 million, net of discount, as of September 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 nine-month periods ended September 30, 2012 and 2011 include the operating results produced by the acquired assets and assumed liabilities from the FDIC-assisted

acquisition.

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

|   | <b>Nine-Month Period Ended September 30,</b> |                   |
|---|--|-------------------|
|   | <b>2012</b>                                  | <b>2011</b>       |
|   | <b>(In thousands)</b>                        |                   |
| <b>Balance at beginning of period</b>                   | \$ 392,367                                   | \$ 473,629        |
| Shared-loss agreements reimbursements from the FDIC     | (63,272)                                     | (73,267)          |
| Increase (decrease) in expected credit losses to be     |  |                   |
| covered under shared-loss agreements, net               | 10,764                                       | (10,659)          |
| Amortization of FDIC shared-loss indemnification asset, |  |                   |
| net   | (18,505)                                     | (191)             |
| Incurred expenses to be reimbursed under shared-loss    |  |                   |
| agreements  | 7,219  | 2,584             |
| <b>Balance at end of period</b>                         | <b>\$ 328,573</b>                            | <b>\$ 392,096</b> |

## 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 September 30, 2012 and December 31, 2011, money market instruments included as part of cash and cash equivalents amounted to \$4.0 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 September 30, 2012, securities purchased under agreements to resell amounted to \$270.0 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 right 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 September 30, 2012 was approximately \$275.4 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 September 30, 2012 and December 31, 2011 were as follows:

|                                   | September 30, 2012 |                              |                               |               |                              |  |
|-----------------------------------|--------------------|------------------------------|-------------------------------|---------------|------------------------------|--|
|                                   | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value | Weighted<br>Average<br>Yield |  |
|                                   | (In thousands)     |                              |                               |               |                              |  |
| <b>Available-for-sale</b>         |                    |                              |                               |               |                              |  |
| <b>Mortgage-backed securities</b> | \$ 1,530,787       | \$ 68,843                    | \$ 1                          | \$ 1,599,629  | 3.10%                        |  |

|  |                     |                   |                 |                     |              |
|--|---------------------|-------------------|-----------------|---------------------|--------------|
| FNMA and FHLMC<br>certificates                     |                     |                   |                 |                     |              |
| GNMA certificates                                  | 17,336              | 1,404             | 8               | 18,732              | 4.89%        |
| CMOs issued by US<br>Government sponsored agencies | 193,543             | 1,770             | 208             | 195,105             | 1.78%        |
| <b>Total mortgage-backed<br/>securities</b>        | <b>1,741,666</b>    | <b>72,017</b>     | <b>217</b>      | <b>1,813,466</b>    | <b>2.97%</b> |
| <b>Investment securities</b>                       |                     |                   |                 |                     |              |
| US Treasury securities                             | 387,992             | 2                 | -               | 387,994             | 0.04%        |
| Obligations of US<br>Government sponsored agencies | 25,017              | 118               | -               | 25,135              | 1.40%        |
| Obligations of Puerto Rico<br>Government and       |                     |                   |                 |                     |              |
| political subdivisions                             | 22,240              | 126               | 12              | 22,354              | 5.41%        |
| Structured credit investments                      | 36,424              | -                 | 7,422           | 29,002              | 2.10%        |
| Other debt securities                              | 15,290              | 309               | -               | 15,599              | 3.44%        |
| <b>Total investment<br/>securities</b>             | <b>486,963</b>      | <b>555</b>        | <b>7,434</b>    | <b>480,084</b>      | <b>0.62%</b> |
| <b>Total securities<br/>available-for-sale</b>     | <b>2,228,629</b>    | <b>72,572</b>     | <b>7,651</b>    | <b>2,293,550</b>    | <b>2.45%</b> |
| <b>Held-to-maturity</b>                            |                     |                   |                 |                     |              |
| <b>Mortgage-backed securities</b>                  |                     |                   |                 |                     |              |
| FNMA and FHLMC<br>certificates                     | 722,823             | 38,283            | -               | 761,106             | 3.30%        |
| CMOs issued by US<br>Government sponsored agencies | 112,261             | 1,554             | -               | 113,815             | 1.97%        |
| <b>Total securities<br/>held-to-maturity</b>       | <b>835,084</b>      | <b>39,837</b>     | <b>-</b>        | <b>874,921</b>      | <b>3.12%</b> |
| <b>Total investments</b>                           | <b>\$ 3,063,713</b> | <b>\$ 112,409</b> | <b>\$ 7,651</b> | <b>\$ 3,168,471</b> | <b>2.63%</b> |



## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

|  | December 31, 2011   |                              |                               |                     |                              |  |
|--|---------------------|------------------------------|-------------------------------|---------------------|------------------------------|--|
|  | Amortized<br>Cost   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value       | Weighted<br>Average<br>Yield |  |
|  | (In thousands)      |                              |                               |                     |                              |  |
| <b>Available-for-sale</b>                          |                     |                              |                               |                     |                              |  |
| <b>Mortgage-backed securities</b>                  |                     |                              |                               |                     |                              |  |
| FNMA and FHLMC<br>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<br>Government sponsored agencies | 128,505             | 1,739                        | 199                           | 130,045             | 2.33%                        |  |
| <b>Total mortgage-backed<br/>securities</b>        | <b>2,738,572</b>    | <b>96,789</b>                | <b>199</b>                    | <b>2,835,162</b>    | <b>3.57%</b>                 |  |
| <b>Investment securities</b>                       |                     |                              |                               |                     |                              |  |
| Obligations of Puerto Rico<br>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%                        |  |
| <b>Total investment<br/>securities</b>             | <b>135,110</b>      | <b>460</b>                   | <b>10,820</b>                 | <b>124,750</b>      | <b>4.29%</b>                 |  |
| <b>Total securities<br/>available-for-sale</b>     | <b>2,873,682</b>    | <b>97,249</b>                | <b>11,019</b>                 | <b>2,959,912</b>    | <b>3.60%</b>                 |  |
| <b>Held-to-maturity</b>                            |                     |                              |                               |                     |                              |  |
| <b>Mortgage-backed securities</b>                  |                     |                              |                               |                     |                              |  |
| FNMA and FHLMC<br>certificates                     | 884,026             | 20,530                       | -                             | 904,556             | 3.34%                        |  |
| <b>Total investments</b>                           | <b>\$ 3,757,708</b> | <b>\$ 117,779</b>            | <b>\$ 11,019</b>              | <b>\$ 3,864,468</b> | <b>3.54%</b>                 |  |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The amortized cost and fair value of the Group's investment securities at September 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.

|  | September 30, 2012 |                  |                  |                |
|--|--------------------|------------------|------------------|----------------|
|  | Available-for-sale |                  | Held-to-maturity |                |
|  | Amortized Cost     | Fair Value       | Amortized Cost   | Fair Value     |
|  | (In thousands)     |                  |                  |                |
| <b>Mortgage-backed securities</b>                                |                    |                  |                  |                |
| Due after 5 to 10 years  |                    |                  |                  |                |
| FNMA and FHLMC certificates                                      | \$ 44,430          | \$ 45,805        | \$ -             | \$ -           |
| <b>Total due after 5 to 10 years</b>                             | <b>44,430</b>      | <b>45,805</b>    | -                | -              |
| Due after 10 years   |                    |                  |                  |                |
| FNMA and FHLMC certificates                                      | 1,486,357          | 1,553,824        | 722,823          | 761,106        |
| GNMA certificates  | 17,336             | 18,732           | -                | -              |
| CMOs issued by US Government sponsored agencies                  | 193,543            | 195,105          | 112,261          | 113,815        |
| <b>Total due after 10 years</b>                                  | <b>1,697,236</b>   | <b>1,767,661</b> | <b>835,084</b>   | <b>874,921</b> |
| <b>Total mortgage-backed securities</b>                          | <b>1,741,666</b>   | <b>1,813,466</b> | <b>835,084</b>   | <b>874,921</b> |
| <b>Investment securities</b>                                     |                    |                  |                  |                |
| Due in less than one year  |                    |                  |                  |                |
| US Treasury securities   | 387,992            | 387,994          | -                | -              |
| <b>Total due in less than one year</b>                           | <b>387,992</b>     | <b>387,994</b>   | -                | -              |
| Due from 1 to 5 years  |                    |                  |                  |                |
| Other debt securities  | 10,000             | 10,017           | -                | -              |
| Obligations of Puerto Rico Government and political subdivisions | 398                | 397              | -                | -              |
| <b>Total due from 1 to 5 years</b>                               | <b>10,398</b>      | <b>10,414</b>    | -                | -              |
| Due after 5 to 10 years  |                    |                  |                  |                |
| Obligations of Puerto Rico Government and political subdivisions | 11,380             | 11,426           | -                | -              |
| Structured credit investments                                    | 36,424             | 29,002           | -                | -              |
| Obligations of US Government and sponsored agencies              | 25,017             | 25,135           | -                | -              |

|  |                     |                     |                   |                   |
|--|---------------------|---------------------|-------------------|-------------------|
| <b>Total due after 5 to 10 years</b>                             | <b>72,821</b>       | <b>65,563</b>       | -                 | -                 |
| Due after 10 years   |                     |                     |                   |                   |
| Obligations of Puerto Rico Government and political subdivisions | 10,462              | 10,531              | -                 | -                 |
| Other debt securities  | 5,290               | 5,582               | -                 | -                 |
| <b>Total due after 10 years</b>                                  | <b>15,752</b>       | <b>16,113</b>       | -                 | -                 |
| <b>Total investment securities</b>                               | <b>486,963</b>      | <b>480,084</b>      | -                 | -                 |
| <b>Total investments</b>   | <b>\$ 2,228,629</b> | <b>\$ 2,293,550</b> | <b>\$ 835,084</b> | <b>\$ 874,921</b> |

Keeping with the Group's investment strategy, during the nine-month period ended September 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. During the quarter ended September 30, 2012, the Group sold \$532.4 million of investment securities and extinguished \$400 million of securities repurchase agreements prior to their contractual maturities in furtherance of the Group's plan to deleverage its balance sheet in connection with the BBVAPR Acquisition.

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 gains and losses 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. During the quarter ended September 30, 2012, the Group made a change in one of the estimates applied in the calculation of the amortization of premiums/discounts in the

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

mortgage-backed securities portfolio. The estimate involves the period used in measuring the repayment experience of each security and the change consists of using a 12-month look-back period instead of a 3-month period for these purposes. The Group believes that this extended period better reflects the portfolio behavior, especially considering the seasonality cycle of the U.S. housing market, and also reduces the high volatility that affects interest income recognition when using a more limited prepayment history experience in periods of greater market volatility. The impact of this change during the quarter ended September 30, 2012 was an increase of \$3.3 million in interest income from mortgage-backed securities.

The Group, as part of its asset/liability management, may purchase U.S. Treasury securities and U.S. 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.

The Group recorded a net gain on sale of securities of \$55.7 million and \$23.1 million during the nine-month periods ended September 30, 2012 and 2011, respectively. The tables below present the gross realized gains and losses by category for the nine-month periods ended September 30, 2012 and 2011:

| <u>Description</u>  | Nine-Month Period Ended September 30, 2012 |                       |                  |                 |
|---|--|-----------------------|------------------|-----------------|
|   | Sale Price                                 | Book Value<br>at Sale | Gross<br>Gains   | Gross<br>Losses |
|   | (In thousands)                             |                       |                  |                 |
| <b>Sale of Securities Available-for-Sale</b>                        |  |                       |                  |                 |
| <b>Mortgage-backed securities</b>                                   |  |                       |                  |                 |
| FNMA and FHLMC certificates   | \$ 936,779                                 | \$ 881,834            | \$ 54,945        | \$ -            |
| GNMA certificates   | 62,639                                     | 62,638                | 1                | -               |
| CMOs issued by US Government<br>sponsored agencies                  | 19,725                                     | 18,372                | 1,353            | -               |
| <b>Total mortgage-backed<br/>securities and CMOs</b>                | <b>1,019,143</b>                           | <b>962,844</b>        | <b>56,299</b>    | <b>-</b>        |
| <b>Investment securities</b>  |  |                       |                  |                 |
| US Treasury securities  | 80,000                                     | 80,000                | -                | -               |
| Obligations of Puerto Rico<br>Government and political subdivisions | 35,882                                     | 36,478                | 32               | 628             |
| Structured credit investments                                       | 10,530                                     | 10,530                | -                | -               |
| <b>Total investment securities</b>                                  | <b>126,412</b>                             | <b>127,008</b>        | <b>32</b>        | <b>628</b>      |
| <b>Total</b>  | <b>\$ 1,145,555</b>                        | <b>\$ 1,089,852</b>   | <b>\$ 56,331</b> | <b>\$ 628</b>   |

| <u>Description</u> | Nine-Month Period Ended September 30, 2011 |                    |             |              |
|--------------------|--|--------------------|-------------|--------------|
|                    | Sale Price                                 | Sale Book<br>Value | Gross Gains | Gross Losses |

(In thousands)

**Sale of Securities Available-for-Sale**

|   |    |                |    |                |    |               |    |          |
|---|----|----------------|----|----------------|----|---------------|----|----------|
| <b>Mortgage-backed securities</b>                 |    |                |    |                |    |               |    |          |
| FNMA and FHLMC certificates                       | \$ | 309,112        | \$ | 293,580        | \$ | 15,532        | \$ | -        |
| GNMA certificates                                 |    | 183,269        |    | 175,699        |    | 7,571         |    | 1        |
| <b>Total mortgage-backed securities</b>           |    | 492,381        |    | 469,279        |    | 23,103        |    | 1        |
| <b>Investment securities</b>                      |    |                |    |                |    |               |    |          |
| Obligations of U.S. Government sponsored agencies |    | 14,100         |    | 14,100         |    | -             |    | -        |
| <b>Total investment securities</b>                |    | 14,100         |    | 14,100         |    | -             |    | -        |
| <b>Total</b>                                      | \$ | <b>506,481</b> | \$ | <b>483,379</b> | \$ | <b>23,103</b> | \$ | <b>1</b> |

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**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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

|  | Amortized<br>Cost | September 30, 2012<br>12 months or more<br>Unrealized<br>Loss<br>(In thousands) |           | Fair<br>Value |
|--|-------------------|---|-----------|---------------|
| <b>Securities Available-for-sale</b>                             |                   |   |           |               |
| Structured credit investments                                    | \$ 36,424         | \$ 7,422  | \$        | 29,002        |
| Obligations of Puerto Rico Government and political subdivisions | 1,653             | 12  |           | 1,641         |
| CMOs issued by US Government sponsored agencies                  | 2,243             | 183   |           | 2,060         |
|  | <b>\$ 40,320</b>  | <b>\$ 7,617</b>   | <b>\$</b> | <b>32,703</b> |

|  | Amortized<br>Cost | Less than 12 months<br>Unrealized<br>Loss<br>(In thousands) |           | Fair<br>Value |
|--|-------------------|---|-----------|---------------|
| <b>Securities Available-for-sale</b>                             |                   |   |           |               |
| CMOs issued by US Government sponsored agencies                  | \$ 13,803         | \$ 25   | \$        | 13,778        |
| Obligations of Puerto Rico Government and political subdivisions | 125               | -   |           | 125           |
| GNMA certificates  | 85                | 8   |           | 77            |
| FNMA and FHLMC certificates                                      | 68                | 1   |           | 67            |
|  | <b>\$ 14,081</b>  | <b>\$ 34</b>  | <b>\$</b> | <b>14,047</b> |

|  | Amortized<br>Cost | TOTAL<br>Unrealized<br>Loss<br>(In thousands) |           | Fair<br>Value |
|--|-------------------|---|-----------|---------------|
| <b>Securities Available-for-sale</b>                             |                   |   |           |               |
| Structured credit investments                                    | \$ 36,424         | \$ 7,422                                      | \$        | 29,002        |
| Obligations of Puerto Rico Government and political subdivisions | 1,778             | 12  |           | 1,766         |
| CMOs issued by US Government sponsored agencies                  | 16,046            | 208   |           | 15,838        |
| FNMA and FHLMC certificates                                      | 68                | 1   |           | 67            |
| GNMA certificates  | 85                | 8   |           | 77            |
|  | <b>\$ 54,401</b>  | <b>\$ 7,651</b>                               | <b>\$</b> | <b>46,750</b> |

**December 31, 2011  
12 months or more**

|   | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Loss<br/>(In thousands)</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---|-----------------------|
| <b>Securities Available-for-sale</b>                                |                           |   |                       |
| Structured credit investments                                       | \$ 36,374                 | \$ 9,616                                      | \$ 26,758             |
| Obligations of Puerto Rico Government and<br>political subdivisions | 24,697                    | 1,204   | 23,493                |
| CMOs issued by US Government sponsored<br>agencies                  | 2,384                     | 199   | 2,185                 |
|   | <b>\$ 63,455</b>          | <b>\$ 11,019</b>                              | <b>\$ 52,436</b>      |

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



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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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 September 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 \$7.4 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.

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, the CLO has maintained its "AA-" S&P rating and its "A2" Moody's rating since November 2011. In addition, as of September 30, 2012 and December 31, 2011, the CLO's subordination level is 26.18%.

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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. The CLO has maintained its “A+” S&P rating and its “A2” Moody’s rating since February 2012. Also, as of September 30, 2012 and December 31, 2011, the CLO’s subordination level is 20.64%.

The cash flow analysis performed by the Group for the \$15 million CLO as of September 30, 2012, detected that there was a principal impairment in 10 out of 100 scenarios, with average losses of 3.42%. and no scenarios where the impairment amount is 100% of the Group’s investment. The CLO has maintained its “BBB+” S&P rating and its “Baa2” Moody’s rating since August 2011. Also, as of September 30, 2012 and December 31, 2011, 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 a projected analysis prepared by a third-party specialist that 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 September 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 September 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 September 30, 2012, the Group does not have the intent to sell these investments in an unrealized loss position.



## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

## NOTE 4 - PLEDGED ASSETS

The following table shows a summary of pledged and not pledged assets at September 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:

|  | September 30, 2012  |           | December 31, 2011 |
|--|---------------------|-----------|-------------------|
|  | (In thousands)      |           |                   |
| <b>Pledged investment securities to secure:</b>      |                     |           |                   |
| Securities sold under agreements to repurchase       | \$ 2,885,058        | \$        | 3,399,145         |
| Puerto Rico public fund deposits                     | 8,522               |           | 71,863            |
| Puerto Rico Cash & Money Market Fund                 | 72,312              |           | 62,739            |
| Interest rate risk swap contracts                    | 56,444              |           | 56,189            |
| Federal Reserve Bank Credit Facility                 | 10,254              |           | 15,560            |
| Bond for the Bank's trust operations                 | 125                 |           | 126               |
| <b>Total pledged investment securities</b>           | <b>3,032,715</b>    |           | <b>3,605,622</b>  |
| <b>Pledged residential mortgage loans to secure:</b> |                     |           |                   |
| Advances from the Federal Home Loan Bank             | <b>515,669</b>      |           | <b>548,809</b>    |
| <b>Pledged commercial loans to secure:</b>           |                     |           |                   |
| Advances from the Federal Home Loan Bank             | 54,614              |           | 40,937            |
| Puerto Rico public fund deposits                     | 2,271               |           | -                 |
|  | <b>56,885</b>       |           | <b>40,937</b>     |
| <b>Pledged leases to secure:</b>                     |                     |           |                   |
| Federal Reserve Bank Credit Facility                 | <b>8,543</b>        |           | <b>7,821</b>      |
| <b>Total pledged assets</b>                          | <b>\$ 3,613,812</b> | <b>\$</b> | <b>4,203,189</b>  |
| <b>Financial assets not pledged:</b>                 |                     |           |                   |
| Investment securities                                | \$ 135,757          | \$        | 258,845           |
| Residential mortgage loans                           | 428,465             |           | 435,716           |
| Commercial loans                                     | 590,795             |           | 603,444           |
| Consumer loans                                       | 54,577              |           | 49,663            |
| Leases   | 37,369              |           | 54,069            |
| <b>Total assets not pledged</b>                      | <b>\$ 1,246,963</b> | <b>\$</b> | <b>1,401,737</b>  |

At September 30, 2012 and December 31, 2011, OIB held a certificate of deposit free of liens in the amount of \$300 thousand as the legal reserve required for international banking entities under Puerto Rico law. Such certificate of deposit cannot be withdrawn by OIB without the OCFI's prior written approval.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

## NOTE 5 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN AND LEASE LOSSES

*Loans Receivable Composition*

The composition of the Group's loan portfolio at September 30, 2012 and December 31, 2011 was as follows:

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
|  | (In thousands)        |                      |
| <b>Loans not covered under shared-loss agreements with FDIC:</b>           |                       |                      |
| <b>Loans secured by real estate:</b>                                       |                       |                      |
| Residential  | \$ 770,979            | \$ 819,651           |
| Home equity loans and others   | 768                   | 1,411                |
| Commercial   | 239,654               | 218,261              |
| Deferred loan fees, net  | (3,962)               | (4,300)              |
|  | 1,007,439             | 1,035,023            |
| <b>Other loans:</b>  |                       |                      |
| Commercial   | 98,710                | 83,312               |
| Personal consumer loans and credit lines                                   | 43,631                | 36,130               |
| Leasing  | 33,772                | 25,768               |
| Deferred loan costs (fees), net  | 87                    | (245)                |
|  | 176,200               | 144,965              |
| <b>Loans receivable</b>  | <b>1,183,639</b>      | <b>1,179,988</b>     |
| Allowance for loan and lease losses on non-covered loans                   | (39,120)              | (37,010)             |
| <b>Loans receivable, net</b>   | <b>1,144,519</b>      | <b>1,142,978</b>     |
| Mortgage loans held-for-sale   | 38,211                | 26,939               |
| <b>Total loans not covered under shared-loss agreements with FDIC, net</b> | <b>1,182,730</b>      | <b>1,169,917</b>     |
| <b>Loans covered under shared-loss agreements with FDIC:</b>               |                       |                      |
| Loans secured by 1-4 family residential properties                         | 138,138               | 140,824              |
| Construction and development secured by 1-4 family residential properties  | 7,933                 | 16,976               |
| Commercial and other construction  | 301,383               | 325,832              |
| Leasing  | 12,140                | 36,122               |
| Consumer   | 10,859                | 13,778               |
| <b>Total loans covered under shared-loss agreements with FDIC</b>          | <b>470,453</b>        | <b>533,532</b>       |
| Allowance for loan and lease losses on covered loans                       | (56,865)              | (37,256)             |
| <b>Total loans covered under shared-loss agreements with FDIC, net</b>     | <b>413,588</b>        | <b>496,276</b>       |
| <b>Total loans receivable, net</b>   | <b>\$ 1,596,318</b>   | <b>\$ 1,666,193</b>  |



## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

*Non-Covered Loans*

The Group's credit activities are mainly with customers located in Puerto Rico. The Group's loan transactions are encompassed within four portfolio segments: mortgage, commercial, consumer and leasing.

The following table presents the aging of the recorded investment in gross loans not covered under shared-loss agreements with the FDIC, excluding mortgage loans held for sale, as of September 30, 2012 and December 31, 2011 by class of loans:

|                                       | September 30, 2012     |                           |  |                   |           |            | Total Loans |
|---------------------------------------|------------------------|---------------------------|--|-------------------|-----------|------------|-------------|
|                                       | 30-59 Days<br>Past Due | 60-89<br>Days<br>Past Due | 90+ Days<br>Past Due<br>(In thousands) | Total Past<br>Due | Current   |            |             |
| <b>Mortgage</b>                       |                        |                           |  |                   |           |            |             |
| Traditional                           |                        |                           |  |                   |           |            |             |
| (by origination<br>year):             |                        |                           |  |                   |           |            |             |
| Up to the year<br>2002                | \$ 3,760               | \$ 793                    | \$ 10,501                              | \$ 15,054         | \$ 87,484 | \$ 102,538 |             |
| Years 2003 and<br>2004                | 7,051                  | 2,398                     | 16,956                                 | 26,405            | 127,625   | 154,030    |             |
| Year 2005                             | 1,538                  | 681                       | 8,027                                  | 10,246            | 73,744    | 83,990     |             |
| Year 2006                             | 4,085                  | 1,251                     | 14,129                                 | 19,465            | 98,143    | 117,608    |             |
| Years 2007, 2008<br>and 2009          | 1,655                  | 738                       | 9,414                                  | 11,807            | 115,050   | 126,857    |             |
| Years 2010, 2011<br>and 2012          | 801                    | 398                       | 670                                    | 1,869             | 43,162    | 45,031     |             |
| Non-traditional                       | 18,890                 | 6,259                     | 59,697                                 | 84,846            | 545,208   | 630,054    |             |
| Loss mitigation<br>program            | 2,153                  | 460                       | 11,177                                 | 13,790            | 48,107    | 61,897     |             |
| Home equity secured<br>personal loans | 6,047                  | 1,475                     | 17,010                                 | 24,532            | 54,496    | 79,028     |             |
|                                       | 27,090                 | 8,194                     | 87,884                                 | 123,168           | 647,811   | 770,979    |             |
|                                       | -                      | -                         | 12                                     | 12                | 756       | 768        |             |



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|  |                  |                 |                   |                   |                     |                     |
|--|------------------|-----------------|-------------------|-------------------|---------------------|---------------------|
|  | <b>27,090</b>    | <b>8,194</b>    | <b>87,896</b>     | <b>123,180</b>    | <b>648,567</b>      | <b>771,747</b>      |
| <b>Commercial</b>  |                  |                 |                   |                   |                     |                     |
| Commercial secured<br>by real estate                     | 1,041            | 369             | 15,768            | 17,178            | 222,476             | 239,654             |
| Other commercial<br>and industrial                       | 240              | 267             | 2,425             | 2,932             | 95,778              | 98,710              |
|  | <b>1,281</b>     | <b>636</b>      | <b>18,193</b>     | <b>20,110</b>     | <b>318,254</b>      | <b>338,364</b>      |
| <b>Consumer</b>  | <b>396</b>       | <b>229</b>      | <b>254</b>        | <b>879</b>        | <b>42,752</b>       | <b>43,631</b>       |
| <b>Leasing</b>   | <b>578</b>       | <b>109</b>      | <b>11</b>         | <b>698</b>        | <b>33,074</b>       | <b>33,772</b>       |
| <b>Total loans not<br/>covered under<br/>shared-loss</b> |                  |                 |                   |                   |                     |                     |
| <b>agreements</b>  |                  |                 |                   |                   |                     |                     |
| <b>with the FDIC</b>                                     | <b>\$ 29,345</b> | <b>\$ 9,168</b> | <b>\$ 106,354</b> | <b>\$ 144,867</b> | <b>\$ 1,042,647</b> | <b>\$ 1,187,514</b> |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

|                           | December 31, 2011      |                           |  |                   |                  |                  |
|---------------------------|------------------------|---------------------------|--|-------------------|------------------|------------------|
|                           | 30-59 Days<br>Past Due | 60-89<br>Days<br>Past Due | 90+ Days<br>Past Due<br>(In thousands) | Total Past<br>Due | Current          | Total Loans      |
| <b>Mortgage</b>           |                        |                           |  |                   |                  |                  |
| Traditional               |                        |                           |  |                   |                  |                  |
| (by origination<br>year): |                        |                           |  |                   |                  |                  |
| Up to the year            | \$                     | \$                        | \$                                     | \$                | \$               | \$               |
| 2002                      | 2,009                  | 1,514                     | 15,638                                 | 19,161            | 95,886           | 115,047          |
| Years 2003 and            | 7,835                  | 3,140                     | 19,692                                 | 30,667            | 138,490          | 169,157          |
| 2004                      |                        |                           |  |                   |                  |                  |
| Year 2005                 | 2,137                  | 2,573                     | 10,325                                 | 15,035            | 77,256           | 92,291           |
| Year 2006                 | 4,018                  | 1,358                     | 17,673                                 | 23,049            | 107,526          | 130,575          |
| Years 2007, 2008          | 2,562                  | 655                       | 8,996                                  | 12,213            | 124,594          | 136,807          |
| and 2009                  |                        |                           |  |                   |                  |                  |
| Years 2010, 2011          | 370                    | 194                       | 513                                    | 1,077             | 40,848           | 41,925           |
| and 2012                  | 18,931                 | 9,434                     | 72,837                                 | 101,202           | 584,600          | 685,802          |
| Non-traditional           | 1,109                  | 819                       | 10,857                                 | 12,785            | 57,240           | 70,025           |
| Loss mitigation           | 4,887                  | 2,113                     | 13,323                                 | 20,323            | 43,501           | 63,824           |
| program                   | 24,927                 | 12,366                    | 97,017                                 | 134,310           | 685,341          | 819,651          |
| Home equity               | 142                    | -                         | 323                                    | 465               | 946              | 1,411            |
| secured personal loans    | <b>25,069</b>          | <b>12,366</b>             | <b>97,340</b>                          | <b>134,775</b>    | <b>686,287</b>   | <b>821,062</b>   |
| <b>Commercial</b>         |                        |                           |  |                   |                  |                  |
| Commercial secured        | 1,205                  | 1,697                     | 27,741                                 | 30,643            | 187,618          | 218,261          |
| by real estate            |                        |                           |  |                   |                  |                  |
| Other commercial          | 1,536                  | 99                        | 616                                    | 2,251             | 81,061           | 83,312           |
| and industrial            | <b>2,741</b>           | <b>1,796</b>              | <b>28,357</b>                          | <b>32,894</b>     | <b>268,679</b>   | <b>301,573</b>   |
| <b>Consumer</b>           | <b>557</b>             | <b>226</b>                | <b>334</b>                             | <b>1,117</b>      | <b>35,013</b>    | <b>36,130</b>    |
| <b>Leasing</b>            | <b>339</b>             | <b>-</b>                  | <b>102</b>                             | <b>441</b>        | <b>25,327</b>    | <b>25,768</b>    |
| <b>Total loans</b>        |                        |                           |  |                   |                  |                  |
| <b>not covered under</b>  |                        |                           |  |                   |                  |                  |
| <b>shared-loss</b>        |                        |                           |  |                   |                  |                  |
| <b>agreements</b>         |                        |                           |  |                   |                  |                  |
| <b>with the FDIC</b>      | \$                     | \$                        | \$                                     | \$                | \$               | \$               |
|                           | <b>28,706</b>          | <b>14,388</b>             | <b>126,133</b>                         | <b>169,227</b>    | <b>1,015,306</b> | <b>1,184,533</b> |



## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table presents the recorded investment in non-covered loans on non-accrual status by class of loans as of September 30, 2012 and December 31, 2011:

|                                    | September 30,<br>2012 | December 31,<br>2011 |
|------------------------------------|-----------------------|----------------------|
|                                    | (In thousands)        |                      |
| <b>Mortgage</b>                    |                       |                      |
| Traditional                        |                       |                      |
| (by origination year):             |                       |                      |
| Up to the year 2002                | \$ 10,501             | \$ 15,637            |
| Years 2003 and 2004                | 16,956                | 19,693               |
| Year 2005                          | 8,027                 | 10,325               |
| Year 2006                          | 14,129                | 17,673               |
| Years 2007, 2008                   | 9,414                 | 8,996                |
| and 2009                           |                       |                      |
| Years 2010, 2011                   | 670                   | 513                  |
| and 2012                           | 59,697                | 72,837               |
| Non-traditional                    | 11,177                | 10,857               |
| Loss mitigation program            | 17,010                | 13,323               |
|                                    | 87,884                | 97,017               |
| Home equity secured personal loans | 12                    | 323                  |
|                                    | <b>87,896</b>         | <b>97,340</b>        |
| <b>Commercial</b>                  |                       |                      |
| Commercial secured by real estate  | 26,959                | 34,789               |
| Other commercial and industrial    | 2,690                 | 2,199                |
|                                    | <b>29,649</b>         | <b>36,988</b>        |
| <b>Consumer</b>                    | <b>276</b>            | <b>334</b>           |
| <b>Leasing</b>                     | <b>11</b>             | <b>102</b>           |
| <b>Total non-accrual loans</b>     | <b>\$ 117,832</b>     | <b>\$ 134,764</b>    |

At September 30, 2012 and December 31, 2011, loans whose terms have been extended and which are classified as troubled-debt restructuring that are not included in non-accrual loans amounted to \$56.6 million and \$41.3 million, respectively.



**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

*Credit Quality Indicators*

The Group categorizes non-covered loans into risk categories 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.

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 that are either over 90 days past due or adversely classified, or when deemed necessary by management. The portfolios of loans secured by residential properties, leases and consumer loans are considered homogeneous, and are evaluated collectively for impairment.

The Group uses the following definitions for risk ratings:

**Special Mention:** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, questionable and improbable.

**Loss:** Loans classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be affected in the future.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

As of September 30, 2012 and December 31, 2011, and based on the most recent analysis performed, the risk category of gross non-covered loans subject to risk rating, by class of loans, is as follows:

|                       | Balance<br>Outstanding | September 30, 2012<br>Risk Ratings |                    |                 |              | Individually<br>Measured<br>for<br>Impairment |
|-----------------------|------------------------|------------------------------------|--------------------|-----------------|--------------|---|
|                       |                        | Pass<br>(In thousands)             | Special<br>Mention | Substandard     | Doubtful     |   |
| <b>Commercial</b>     |                        |                                    |                    |                 |              |   |
| Commercial<br>secured |                        |                                    |                    |                 |              |   |
| by real<br>estate     | \$ 239,654             | \$ 182,898                         | \$ 23,390          | \$ 1,957        | \$ 99        | \$ 31,310                                     |
| Other<br>commercial   |                        |                                    |                    |                 |              |   |
| and<br>industrial     | 98,710                 | 86,886                             | 6,823              | 394             | -            | 4,607   |
| <b>Total</b>          | <b>\$ 338,364</b>      | <b>\$ 269,784</b>                  | <b>\$ 30,213</b>   | <b>\$ 2,351</b> | <b>\$ 99</b> | <b>\$ 35,917</b>                              |

|                       | Balance<br>Outstanding | December 31, 2011<br>Risk Ratings |                    |             |          | Individually<br>Measured<br>for<br>Impairment |
|-----------------------|------------------------|-----------------------------------|--------------------|-------------|----------|---|
|                       |                        | Pass<br>(In thousands)            | Special<br>Mention | Substandard | Doubtful |   |
| <b>Commercial</b>     |                        |                                   |                    |             |          |   |
| Commercial<br>secured |                        |                                   |                    |             |          |   |
| by real<br>estate     | \$ 218,261             | \$ 148,894                        | \$ 25,185          | \$ 1,957    | \$ 13    | \$ 42,212                                     |
| Other<br>commercial   | 83,312                 | 74,714                            | 3,517              | 929         | -        | 4,152   |



|                                   |    |                |    |                |    |               |    |              |    |           |    |               |
|-----------------------------------|----|----------------|----|----------------|----|---------------|----|--------------|----|-----------|----|---------------|
| and<br>industrial<br><b>Total</b> | \$ | <b>301,573</b> | \$ | <b>223,608</b> | \$ | <b>28,702</b> | \$ | <b>2,886</b> | \$ | <b>13</b> | \$ | <b>46,364</b> |
|-----------------------------------|----|----------------|----|----------------|----|---------------|----|--------------|----|-----------|----|---------------|

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**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

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For residential and consumer loan classes, the Group also evaluates credit quality based on the delinquency status of the loan. As of September 30, 2012 and December 31, 2011, and based on the most recent analysis performed, the risk category of gross non-covered loans not subject to risk rating, by class of loans, is as follows:

| Balance                       | September 30, 2012<br>Delinquency |                   |                  |                 |                 |                  | Impairment       |                  |
|-------------------------------|-----------------------------------|-------------------|------------------|-----------------|-----------------|------------------|------------------|------------------|
|                               | Individually<br>Measured<br>for   |                   | Outstanding      |                 |                 |                  |                  |                  |
|                               |                                   |                   | 0-29<br>days     | 30-59<br>days   | 60-89<br>days   | 90-119<br>days   | 120-364<br>days  | 365+<br>days     |
|                               | (In thousands)                    |                   |                  |                 |                 |                  |                  |                  |
| Mortgage<br>Traditional       |                                   |                   |                  |                 |                 |                  |                  |                  |
| (by<br>origination year):     |                                   |                   |                  |                 |                 |                  |                  |                  |
| Up to the<br>year 2002        | \$ 102,538                        | \$ 87,483         | \$ 3,760         | \$ 793          | \$ 846          | \$ 2,580         | \$ 7,076         | \$ -             |
| Years 2003<br>and 2004        | 154,030                           | 127,625           | 7,051            | 2,398           | 596             | 4,857            | 11,503           | -                |
| Year 2005                     | 83,990                            | 73,745            | 1,538            | 681             | 204             | 2,916            | 4,906            | -                |
| Year 2006                     | 117,608                           | 98,143            | 4,085            | 1,251           | 641             | 4,588            | 8,900            | -                |
| Years 2007,<br>2008           |                                   |                   |                  |                 |                 |                  |                  |                  |
| and 2009                      | 126,857                           | 115,050           | 1,655            | 738             | 514             | 3,582            | 5,318            | -                |
| Years 2010,<br>2011           |                                   |                   |                  |                 |                 |                  |                  |                  |
| and 2012                      | 45,031                            | 43,162            | 801              | 398             | -               | 165              | 505              | -                |
|                               | 630,054                           | 545,208           | 18,890           | 6,259           | 2,801           | 18,688           | 38,208           | -                |
| Non-traditional               | 61,897                            | 48,107            | 2,153            | 460             | 289             | 2,623            | 8,265            | -                |
| Loss<br>mitigation<br>program | 79,028                            | 9,856             | 344              | 177             | 54              | 912              | 2,815            | 64,870           |
|                               | 770,979                           | 603,171           | 21,387           | 6,896           | 3,144           | 22,223           | 49,288           | 64,870           |
| Home equity<br>secured        |                                   |                   |                  |                 |                 |                  |                  |                  |
| personal<br>loans             | 768                               | 756               | -                | -               | -               | -                | 12               | -                |
|                               | 771,747                           | 603,927           | 21,387           | 6,896           | 3,144           | 22,223           | 49,300           | 64,870           |
| Consumer                      | 43,631                            | 42,752            | 396              | 229             | 100             | 151              | 3                | -                |
| Leasing                       | 33,772                            | 33,074            | 578              | 109             | 4               | 1                | 6                | -                |
| <b>Total</b>                  | <b>\$ 849,150</b>                 | <b>\$ 679,753</b> | <b>\$ 22,361</b> | <b>\$ 7,234</b> | <b>\$ 3,248</b> | <b>\$ 22,375</b> | <b>\$ 49,309</b> | <b>\$ 64,870</b> |



## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

| Balance                       | December 31, 2011<br>Delinquency |                   | Individually<br>Measured<br>for | Outstanding      | 0-29<br>days    | 30-59<br>days    | 60-89<br>days    | 90-119<br>days   | 120-364<br>days | 365+<br>days | Impairment |
|-------------------------------|----------------------------------|-------------------|---------------------------------|------------------|-----------------|------------------|------------------|------------------|-----------------|--------------|------------|
|                               |                                  |                   |                                 |                  |                 |                  |                  |                  |                 |              |            |
| Mortgage<br>Traditional       |                                  |                   |                                 |                  |                 |                  |                  |                  |                 |              |            |
| (by<br>origination year)      |                                  |                   |                                 |                  |                 |                  |                  |                  |                 |              |            |
| Up to the<br>year 2002        | \$ 115,047                       | \$ 95,886         | \$ 2,009                        | \$ 1,514         | \$ 406          | \$ 4,972         | \$ 10,260        | \$ -             |                 |              |            |
| Years 2003<br>and 2004        | 169,157                          | 138,490           | 7,835                           | 3,140            | 939             | 7,318            | 11,435           | -                |                 |              |            |
| Year 2005                     | 92,291                           | 77,255            | 2,137                           | 2,573            | 945             | 3,117            | 6,264            | -                |                 |              |            |
| Year 2006                     | 130,575                          | 107,526           | 4,018                           | 1,358            | 446             | 7,416            | 9,811            | -                |                 |              |            |
| Years 2007,<br>2008           |                                  |                   |                                 |                  |                 |                  |                  |                  |                 |              |            |
| and 2009                      | 136,807                          | 124,595           | 2,562                           | 655              | 1,039           | 3,224            | 4,732            | -                |                 |              |            |
| Years 2010<br>and 2011        | 41,925                           | 40,848            | 370                             | 194              | -               | 410              | 103              | -                |                 |              |            |
|                               | 685,802                          | 584,600           | 18,931                          | 9,434            | 3,775           | 26,457           | 42,605           | -                |                 |              |            |
| Non-traditional               | 70,025                           | 57,240            | 1,109                           | 819              | 849             | 2,725            | 7,283            | -                |                 |              |            |
| Loss<br>mitigation<br>program | 63,824                           | 7,928             | 601                             | 757              | -               | 1,002            | 2,054            | 51,482           |                 |              |            |
|                               | 819,651                          | 649,768           | 20,641                          | 11,010           | 4,624           | 30,184           | 51,942           | 51,482           |                 |              |            |
| Home equity<br>secured        |                                  |                   |                                 |                  |                 |                  |                  |                  |                 |              |            |
| personal                      |                                  |                   |                                 |                  |                 |                  |                  |                  |                 |              |            |
| loans                         | 1,411                            | 946               | 142                             | -                | -               | -                | 323              | -                |                 |              |            |
|                               | 821,062                          | 650,714           | 20,783                          | 11,010           | 4,624           | 30,184           | 52,265           | 51,482           |                 |              |            |
| Consumer                      | 36,130                           | 35,013            | 557                             | 226              | 202             | 132              | -                | -                |                 |              |            |
| Leasing                       | 25,768                           | 25,327            | 339                             | -                | 21              | 81               | -                | -                |                 |              |            |
| <b>Total</b>                  | <b>\$ 882,960</b>                | <b>\$ 711,054</b> | <b>\$ 21,679</b>                | <b>\$ 11,236</b> | <b>\$ 4,847</b> | <b>\$ 30,397</b> | <b>\$ 52,265</b> | <b>\$ 51,482</b> |                 |              |            |



## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table presents the troubled-debt restructurings modified during the nine-month periods ended September 30, 2012 and 2011:

## Nine-Month Period Ended September 30, 2012

|                  | Pre Modification    |                     | Pre-Modification      |                                   | Post-Modification   |                     | Post-Modification     |                                   |
|------------------|---------------------|---------------------|-----------------------|-----------------------------------|---------------------|---------------------|-----------------------|-----------------------------------|
|                  | Number of contracts | Recorded Investment | Weighted Average Rate | Weighted Average Term (in Months) | Number of contracts | Recorded Investment | Weighted Average Rate | Weighted Average Term (in Months) |
| Mortgage loans   | 155                 | \$ 23,701           | 6.44%                 | 310                               | \$ 25,385           | 4.86%               | 400                   |                                   |
| Commercial loans | 7                   | 6,981               | 6.13%                 | 46                                | 6,550               | 6.17%               | 46                    |                                   |

## Nine-Month Period Ended September 30, 2011

|                  | Pre Modification    |                     | Pre-Modification      |                                   | Post-Modification   |                     | Post-Modification     |                                   |
|------------------|---------------------|---------------------|-----------------------|-----------------------------------|---------------------|---------------------|-----------------------|-----------------------------------|
|                  | Number of contracts | Recorded Investment | Weighted Average Rate | Weighted Average Term (in Months) | Number of contracts | Recorded Investment | Weighted Average Rate | Weighted Average Term (in Months) |
| Mortgage loans   | 101                 | \$ 14,023           | 6.88%                 | 329                               | \$ 15,112           | 5.87%               | 379                   |                                   |
| Commercial loans | 10                  | 13,117              | 3.61%                 | 77                                | 13,046              | 3.36%               | 75                    |                                   |

The following table presents troubled-debt restructurings modified and for which there was a payment default during the twelve-month periods ended September 30, 2012 and 2011:

|                | Twelve-Month Period Ended September 30, 2012 |                     | Twelve-Month Period Ended September 30, 2011 |                     |
|----------------|--|---------------------|--|---------------------|
|                | Number of contracts                          | Recorded Investment | Number of contracts                          | Recorded Investment |
| Mortgage loans | 37   | \$ 5,029            | 28   | \$ 3,738            |
| Commercial     | -  | \$ -                | 4  | \$ 9,254            |





**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)***Allowance for Loan and Lease Losses***Non-Covered Loans**

The Group maintains an allowance for loan and lease losses at a level that management considers adequate to provide for probable losses based upon an evaluation of known and inherent risks. The Group's allowance for loan and lease losses policy provides for a detailed quarterly analysis of probable losses. The analysis includes a review of historical loan loss experience, value of underlying collateral, current economic conditions, financial condition of borrowers and other pertinent factors. While management uses available information in estimating probable loan losses, future additions to the allowance may be required based on factors beyond the Group's control.

The following table presents the changes and the balance in the allowance for loan and lease losses for the quarters and nine-month periods ended September 30, 2012 and 2011:

|  | <b>Mortgage</b>       | <b>Quarter Ended September 30, 2012</b> |                 |                |                    | <b>Total</b>     |
|--|-----------------------|---|-----------------|----------------|--------------------|------------------|
|  |                       | <b>Commercial</b>                       | <b>Consumer</b> | <b>Leasing</b> | <b>Unallocated</b> |                  |
|  | <b>(In thousands)</b> |   |                 |                |                    |                  |
| <b>Allowance for loan and lease losses for</b>                 |                       |   |                 |                |                    |                  |
| <b>non-covered loans:</b>                                      |                       |   |                 |                |                    |                  |
| Balance at beginning of period                                 | 19,788                | \$ 15,978                               | \$ 998          | \$ 197         | \$ 441             | \$ 37,402        |
| Charge-offs  | (1,752)               | (65)                                    | (198)           | (75)           | -                  | (2,090)          |
| Recoveries   | 131                   | 28                                      | 46              | 3              | -                  | 208              |
| Provision for (recapture of) non-covered loan and lease losses | 2,886                 | (502)                                   | 328             | 119            | 769                | 3,600            |
| <b>Balance at end of period</b>                                | <b>21,053</b>         | <b>\$ 15,439</b>                        | <b>\$ 1,174</b> | <b>\$ 244</b>  | <b>\$ 1,210</b>    | <b>\$ 39,120</b> |

**Quarter Ended September 30, 2011**

|  | <b>Mortgage</b>       | <b>Commercial</b> | <b>Consumer</b> | <b>Leasing</b>  | <b>Unallocated</b> | <b>Total</b>     |
|--|-----------------------|-------------------|-----------------|-----------------|--------------------|------------------|
|  | <b>(In thousands)</b> |                   |                 |                 |                    |                  |
| <b>Allowance for loan and lease losses for</b>                 |                       |                   |                 |                 |                    |                  |
| <b>non-covered loans:</b>                                      |                       |                   |                 |                 |                    |                  |
| Balance at beginning of period                                 | 17,770                | \$ 13,800         | \$ 1,520        | \$ 868          | \$ 271             | \$ 34,229        |
| Charge-offs  | (1,391)               | (440)             | (368)           | (82)            | -                  | (2,281)          |
| Recoveries   | -                     | 56                | 63              | 2               | -                  | 121              |
| Provision for (recapture of) non-covered loan and lease losses | 4,851                 | (2,297)           | 486             | 659             | 101                | 3,800            |
| <b>Balance at end of period</b>                                | <b>21,230</b>         | <b>\$ 11,119</b>  | <b>\$ 1,701</b> | <b>\$ 1,447</b> | <b>\$ 372</b>      | <b>\$ 35,869</b> |

|  | <b>Nine-Month Period Ended September 30, 2012</b> |                   |                 |                |                    |                  |
|--|---|-------------------|-----------------|----------------|--------------------|------------------|
|  | <b>Mortgage</b>                                   | <b>Commercial</b> | <b>Consumer</b> | <b>Leasing</b> | <b>Unallocated</b> | <b>Total</b>     |
|  | <b>(In thousands)</b>                             |                   |                 |                |                    |                  |
| <b>Allowance for loan and lease losses for</b>                 |   |                   |                 |                |                    |                  |
| <b>non-covered loans:</b>                                      |   |                   |                 |                |                    |                  |
| Balance at beginning of period                                 | 21,652  | \$ 12,548         | \$ 1,423        | \$ 845         | \$ 542             | \$ 37,010        |
| Charge-offs  | (4,621)   | (3,423)           | (563)           | (104)          | -                  | (8,711)          |
| Recoveries   | 131   | 129               | 153             | 8              | -                  | 421              |
| Provision for (recapture of) non-covered loan and lease losses | 3,891   | 6,185             | 161             | (505)          | 668                | 10,400           |
| <b>Balance at end of period</b>                                | <b>21,053</b>                                     | <b>\$ 15,439</b>  | <b>\$ 1,174</b> | <b>\$ 244</b>  | <b>\$ 1,210</b>    | <b>\$ 39,120</b> |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

|  | Nine-Month Period Ended September 30, 2011 |                  |                 |                 |               |                  | Total |
|--|--|------------------|-----------------|-----------------|---------------|------------------|-------|
|  | Mortgage                                   | Commercial       | Consumer        | Leasing         | Unallocated   |                  |       |
|  | (In thousands)                             |                  |                 |                 |               |                  |       |
| <b>Allowance for loan and lease losses for</b>                 |  |                  |                 |                 |               |                  |       |
| <b>non-covered loans:</b>                                      |  |                  |                 |                 |               |                  |       |
| Balance at beginning of period                                 | \$ 16,179                                  | \$ 11,153        | \$ 2,286        | \$ 860          | \$ 952        | \$ 31,430        |       |
| Charge-offs  | (4,480)                                    | (1,478)          | (1,160)         | (174)           | -             | (7,292)          |       |
| Recoveries   | 45   | 108              | 175             | 3               | -             | 331              |       |
| Provision for (recapture of) non-covered loan and lease losses | 9,486                                      | 1,336            | 400             | 758             | (580)         | 11,400           |       |
| <b>Balance at end of period</b>                                | <b>\$ 21,230</b>                           | <b>\$ 11,119</b> | <b>\$ 1,701</b> | <b>\$ 1,447</b> | <b>\$ 372</b> | <b>\$ 35,869</b> |       |

The following table presents the recorded investment in gross loans by portfolio segment and based on the impairment method as of September 30, 2012 and 2011:

|   | September 30, 2012 |                  |                 |               |                 |                  | Total |
|---|--------------------|------------------|-----------------|---------------|-----------------|------------------|-------|
|   | Mortgage           | Commercial       | Consumer        | Leasing       | Unallocated     |                  |       |
|   | (In thousands)     |                  |                 |               |                 |                  |       |
| <b>Allowance for loan and lease losses for</b>  |                    |                  |                 |               |                 |                  |       |
| <b>non-covered loans:</b>                       |                    |                  |                 |               |                 |                  |       |
| Ending allowance balance attributable to loans: |                    |                  |                 |               |                 |                  |       |
| Individually evaluated for impairment           | \$ 4,833           | \$ 1,317         | \$ -            | \$ -          | \$ -            | \$ 6,150         |       |
| Collectively evaluated for impairment           | 16,220             | 14,122           | 1,174           | 244           | 1,210           | 32,970           |       |
|   | <b>\$ 21,053</b>   | <b>\$ 15,439</b> | <b>\$ 1,174</b> | <b>\$ 244</b> | <b>\$ 1,210</b> | <b>\$ 39,120</b> |       |

|   |    |                |    |                |    |               |    |                  |
|---|----|----------------|----|----------------|----|---------------|----|------------------|
| <b>Total ending allowance balance</b>         |    |                |    |                |    |               |    |                  |
| <b>Loans:</b>                                 |    |                |    |                |    |               |    |                  |
| Individually evaluated for impairment         | \$ | 64,870         | \$ | 35,917         | \$ | -             | \$ | 100,787          |
| Collectively evaluated for impairment         |    | 706,877        |    | 302,447        |    | 43,631        |    | 1,086,727        |
|   |    |                |    |                |    | 33,772        |    |                  |
| <b>Total ending non-covered loans balance</b> | \$ | <b>771,747</b> | \$ | <b>338,364</b> | \$ | <b>43,631</b> | \$ | <b>33,772</b>    |
|   |    |                |    |                |    |               |    | <b>-</b>         |
|   |    |                |    |                |    |               |    | <b>1,187,514</b> |

|   |                | September 30, 2011 |          |                |             |               |    |                  |
|---|----------------|--------------------|----------|----------------|-------------|---------------|----|------------------|
|   | Mortgage       | Commercial         | Consumer | Leasing        | Unallocated | Total         |    |                  |
|   | (In thousands) |                    |          |                |             |               |    |                  |
| <b>Allowance for loan and lease losses for non-covered loans:</b> |                |                    |          |                |             |               |    |                  |
| Ending allowance balance attributable to loans:                   |                |                    |          |                |             |               |    |                  |
| Individually evaluated for impairment                             | \$             | 2,973              | \$       | 1,829          | \$          | -             | \$ | 4,802            |
| Collectively evaluated for impairment                             |                | 18,257             |          | 9,290          |             | 1,701         |    | 31,067           |
|   |                |                    |          |                |             | 1,447         |    | 372              |
| <b>Total ending allowance balance</b>                             | \$             | <b>21,230</b>      | \$       | <b>11,119</b>  | \$          | <b>1,701</b>  | \$ | <b>1,447</b>     |
|   |                |                    |          |                |             |               |    | <b>372</b>       |
|   |                |                    |          |                |             |               |    | <b>35,869</b>    |
| <b>Loans:</b>   |                |                    |          |                |             |               |    |                  |
| Individually evaluated for impairment                             | \$             | 46,513             | \$       | 35,073         | \$          | -             | \$ | 81,586           |
| Collectively evaluated for impairment                             |                | 790,651            |          | 235,560        |             | 37,241        |    | 1,084,735        |
|   |                |                    |          |                |             | 21,283        |    |                  |
| <b>Total ending non-covered loans balance</b>                     | \$             | <b>837,164</b>     | \$       | <b>270,633</b> | \$          | <b>37,241</b> | \$ | <b>21,283</b>    |
|   |                |                    |          |                |             |               |    | <b>-</b>         |
|   |                |                    |          |                |             |               |    | <b>1,166,321</b> |

The Group evaluates all loans, some individually and others as homogeneous groups, for purposes of determining impairment. The total investment in impaired commercial loans was \$35.9 million and \$46.4 million at September 30, 2012 and December 31, 2011, respectively. The impaired commercial loans were measured based on the fair value of collateral or the present value of cash flows method, including those identified as troubled-debt restructurings. The valuation allowance for impaired commercial loans amounted to approximately \$1.3 million and \$3.5 million at

September 30, 2012 and December 31, 2011, respectively. The total investment in impaired mortgage loans was \$64.9 million and \$51.5 million at September 30, 2012 and December 31, 2011, respectively. Impairment on mortgage loans assessed as troubled-debt restructurings was measured using the present value of cash flows. The valuation allowance for impaired mortgage loans amounted to approximately \$4.8 million and \$3.4 million at September 30, 2012 and December 31, 2011, respectively.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Group's recorded investment in commercial and mortgage loans that were individually evaluated for impairment, excluding FDIC covered loans, and the related allowance for loan and lease losses at September 30, 2012 and December 31, 2011 are as follows:

|   |                  | September 30, 2012                    |                    |                 |           |
|---|------------------|---------------------------------------|--------------------|-----------------|-----------|
|   | Unpaid Principal | Recorded Investment<br>(In thousands) | Specific Allowance | Coverage        |           |
| Impaired loans with specific allowance    |                  |                                       |                    |                 |           |
| Commercial                                | \$               | 15,323                                | \$ 12,260          | \$ 1,317        | 11%       |
| Residential troubled-debt restructuring   |                  | 66,556                                | 64,870             | 4,833           | 7%        |
| Impaired loans with no specific allowance |                  |                                       |                    |                 |           |
| Commercial                                |                  | 26,709                                | 23,657             | N/A             | N/A       |
| <b>Total investment in impaired loans</b> | \$               | <b>108,588</b>                        | \$ <b>100,787</b>  | \$ <b>6,150</b> | <b>6%</b> |

|   |                  | December 31, 2011                     |                    |                 |           |
|---|------------------|---------------------------------------|--------------------|-----------------|-----------|
|   | Unpaid Principal | Recorded Investment<br>(In thousands) | Specific Allowance | Coverage        |           |
| Impaired loans with specific allowance    |                  |                                       |                    |                 |           |
| Commercial                                | \$               | 25,974                                | \$ 23,368          | \$ 3,518        | 15%       |
| Residential troubled-debt restructuring   |                  | 52,480                                | 51,482             | 3,355           | 7%        |
| Impaired loans with no specific allowance |                  |                                       |                    |                 |           |
| Commercial                                |                  | 23,780                                | 22,996             | N/A             | N/A       |
| <b>Total investment in impaired loans</b> | \$               | <b>102,234</b>                        | \$ <b>97,846</b>   | \$ <b>6,873</b> | <b>7%</b> |

The following table presents the interest recognized in commercial and mortgage loans that were individually evaluated for impairment, excluding FDIC covered loans for the quarters and nine-month periods ended September 30, 2012 and 2011:

|  | Quarter Ended September 30,   |   |                                  |                                   |
|--|-------------------------------|---|----------------------------------|-----------------------------------|
|  | 2012                          |   | 2011                             |                                   |
|  | Interest Income<br>Recognized | Average<br>Recorded<br>Investment<br>(In thousands) | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment |
| Impaired loans with specific allowance           |                               |   |                                  |                                   |
| Commercial                                       | \$ 40                         | \$ 9,027  | \$ 277                           | \$ 17,494                         |
| Residential troubled-debt restructuring          | 510                           | 65,932  | 336                              | 47,350                            |
| Impaired loans with no specific allowance        |                               |   |                                  |                                   |
| Commercial                                       | 83                            | 28,475  | 196                              | 18,241                            |
| <b>Total interest income from impaired loans</b> | <b>\$ 633</b>                 | <b>\$ 103,434</b>                                   | <b>\$ 809</b>                    | <b>\$ 83,085</b>                  |

|  | Nine-Month Period Ended September 30, |                                   |                               |                                   |
|--|---------------------------------------|-----------------------------------|-------------------------------|-----------------------------------|
|  | 2012                                  |                                   | 2011                          |                                   |
|  | Interest Income<br>Recognized         | Average<br>Recorded<br>Investment | Interest Income<br>Recognized | Average<br>Recorded<br>Investment |
| Impaired loans with specific allowance           |                                       |                                   |                               |                                   |
| Commercial                                       | \$ 163                                | \$ 16,686                         | \$ 810                        | \$ 16,257                         |
| Residential troubled-debt restructuring          | 1,344                                 | 61,622                            | 777                           | 39,912                            |
| Impaired loans with no specific allowance        |                                       |                                   |                               |                                   |
| Commercial                                       | 261                                   | 24,068                            | 555                           | 15,295                            |
| <b>Total interest income from impaired loans</b> | <b>\$ 1,768</b>                       | <b>\$ 102,376</b>                 | <b>\$ 2,142</b>               | <b>\$ 71,464</b>                  |

**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)****Covered Loans under ASC 310-30**

The Group's acquired loans under the FDIC-assisted acquisition of Eurobank were initially recorded at fair value, and no separate valuation allowance was recorded at the date of acquisition. The Group reviewed each loan at acquisition to determine if it should be accounted for under ASC 310-30 and, if so, determine whether each loan is to be accounted for individually or whether loans will be aggregated into pools of loans based on common risk characteristics. During the evaluation of whether a loan was considered impaired under ASC 310-30, the Group considered a number of factors, including the delinquency status of the loan, payment options and other loan features (i.e., reduced documentation, interest only, or negative amortization features), the geographic location of the borrower or collateral and the risk ratings assigned to the loans. In instances where it was determined that for some of the loans in the acquired loan pool that it is probable that all the contractual payments would be received (therefore the loans meet the first criteria of ASC 310-30-15-2 but not the second), the Group applied the discount accretion guidance as ASC 310-30, instead of the standard loan discount accretion guidance of ASC 310-20 to those loans (the loans under SOP 03-3). As documented in a letter from the AICPA Depository Institution Expert Panel to the Office of Chief Accountant of the SEC, on December 5, 2009, the SEC addressed the recognition of discount accretion for loans acquired under these circumstances. As referred to in the AICPA's letter, when loans are acquired with at a discount attributable in part to credit (e.g., at a fair value lower than the contractual amounts due) and such loans are not within the scope of ASC 310-30, the AICPA believed that the SEC would not object to an accounting policy based on contractual cash flows or an accounting policy based on expected cash flows, meaning that an entity could either apply the accretion guidance of ASC 310-20 or that of the ASC 310-30 to such loans. Consistent with the AICPA's views, the Group applied the guidance of ASC 310-30 to all loans acquired in the transaction including loans that do not meet the scope of ASC 310-30. Based on the criteria, the Group considered the entire portfolio acquired in the FDIC-assisted acquisition, except for credit cards, to be impaired and accounted for under ASC 310-30. Credit cards were accounted under ASC 310-20.

To the extent credit deterioration occurs in covered loans after the date of acquisition, the Group will record an allowance for loan and lease losses and an increase in the FDIC shared-loss indemnification asset for the expected reimbursement from the FDIC under the shared-loss agreements. The covered loans carrying amounts included in the balance sheet at September 30, 2012 and December 31, 2011 are as follows:

|   | <b>September 30, 2012</b> | <b>December 31, 2011</b> |
|---|---------------------------|--------------------------|
|   | <b>(In thousands)</b>     |                          |
| Contractual required payments receivable          | \$ 918,289                | \$ 1,134,524             |
| Less: Non-accretable discount                     | 264,003                   | 412,170                  |
| Cash expected to be collected                     | 654,286                   | 722,354                  |
| Less: Accretable yield                            | 183,833                   | 188,822                  |
| Carrying amount, gross                            | 470,453                   | 533,532                  |
| Less: Allowance for covered loan and lease losses | 56,865                    | 37,256                   |



|                             |           |                |           |                |
|-----------------------------|-----------|----------------|-----------|----------------|
| <b>Carrying amount, net</b> | <b>\$</b> | <b>413,588</b> | <b>\$</b> | <b>496,276</b> |
|-----------------------------|-----------|----------------|-----------|----------------|

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## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following tables describe the accretable yield and non-accretable discount activity for the quarters and nine-month periods ended September 30, 2012 and 2011:

|                                       | Quarter Ended September 30, |                   | Nine-Month Period Ended September 30, |                   |
|---------------------------------------|-----------------------------|-------------------|---------------------------------------|-------------------|
|                                       | 2012                        | 2011              | 2012                                  | 2011              |
|                                       | (In thousands)              |                   | (In thousands)                        |                   |
| <b>Accretable Yield Activity</b>      |                             |                   |                                       |                   |
| Balance at beginning of period        | \$ 177,248                  | \$ 115,722        | \$ 188,822                            | \$ 148,556        |
| Accretion                             | (22,283)                    | (18,222)          | (64,167)                              | (45,507)          |
| Transfer from non-accretable discount | 28,868                      | 70,906            | 59,178                                | 65,357            |
| <b>Balance at end of period</b>       | <b>\$ 183,833</b>           | <b>\$ 168,406</b> | <b>\$ 183,833</b>                     | <b>\$ 168,406</b> |

|   | Quarter Ended September 30, |                   | Nine-Month Period Ended September 30, |                   |
|---|-----------------------------|-------------------|---------------------------------------|-------------------|
|   | 2012                        | 2011              | 2012                                  | 2011              |
|   | (In thousands)              |                   | (In thousands)                        |                   |
| <b>Non-Accretable Discount Activity</b> |                             |                   |                                       |                   |
| Balance at beginning of period          | \$ 314,404                  | \$ 557,938        | \$ 412,170                            | \$ 603,296        |
| Principal losses                        | (21,533)                    | (24,930)          | (88,989)                              | (75,837)          |
| Transfer to accretable yield            | (28,868)                    | (70,906)          | (59,178)                              | (65,357)          |
| <b>Balance at end of period</b>         | <b>\$ 264,003</b>           | <b>\$ 462,102</b> | <b>\$ 264,003</b>                     | <b>\$ 462,102</b> |

For covered loans, as part of the evaluation of actual versus expected cash flows, the Group assesses on a quarterly basis the credit quality of these loans based on delinquency, severity factors and risk ratings, among other assumptions. Migration and credit quality trends are assessed at the pool level, by comparing information from the latest evaluation period through the end of the reporting period. During the first quarter of 2012, the Group reviewed certain pools composed of commercial real estate, construction and development loans, which have been in non-accrual status since acquisition, whose cash flows were lower than the expectations exceeding the established thresholds. The Group reviewed the timing of the collections expected through workouts and/or the timing assessed for the particular workout loan to foreclose for the most significant loans comprising the particular pools selected for review. The credit quality assumptions for these pools were updated to reflect increases in default rates, severities and extension of recovery lags resulting in an increase in the provision for covered loan and lease losses. For other pools composed of performing commercial real estate loans and leases, the Group noted that the actual cash flows were better than expected. Thus, for these pools a reversal of previously recorded allowance and a re-yielding of the leasing pools were recorded. As a result of such assessment, during the first quarter of 2012, the Group recorded a net increase in the allowance for covered loans of \$19.2 million which was partially offset by an increase in the FDIC shared-loss indemnification asset of \$12.0 million. Also, as part of our quarterly assessment of the actual versus

expected cash flows for covered loans, during the second quarter of 2012, the Group reviewed particular loan performances and expected workout developments to derive more assumptions on certain pools secured by real estate and pools of commercial and industrial loans. Certain pools of loans secured by real estate and a pool of loans secured by farmland underperformed in their actual cash flows, and an impairment of \$2.2 million was recorded during that quarter. Such amount was partially offset by an increase in the FDIC shared-loss indemnification asset of \$724 thousand. For the quarter ended September 30, 2012, the assessment of actual versus expected cash flows resulted in a net provision of \$221 thousand as certain pools of real estate backed loans and of commercial and industrial loans underperformed. The net provision also included the reversal of a previously recorded allowance in certain commercial real estate and construction pools whose loans the Group has managed to workout with better outcomes than forecasted.

The loss share portion of the reversal of allowance during the quarter ended September 30, 2012 was proportionally higher than the allowance reversal recorded on the impaired loans. This resulted from the fact that there were some pools in which additional allowance was recognized but no adjustment was done to the FDIC shared-loss indemnification asset as these losses were not covered by a loss share agreement. This resulted in the reduction of the FDIC shared-loss indemnification asset of \$1.9 million that is part of the aforementioned net provision for covered loans of \$221 thousand.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The changes in the allowance for loan and lease losses on covered loans for the quarters and nine-month periods ended September 30, 2012 and 2011 were as follows:

|   | Quarter Ended September 30, |                  | Nine-Month Period Ended |                  |
|---|-----------------------------|------------------|-------------------------|------------------|
|   | 2012                        | 2011             | September 30,           | 2011             |
|   | (In thousands)              |                  | (In thousands)          |                  |
| Balance at beginning of the period  | \$ 58,628                   | \$ 53,036        | \$ 37,256               | \$ 49,286        |
| Provision for (recapture of) covered loan and lease losses, net                             | 221                         | (1,936)          | 8,845                   | (1,387)          |
| FDIC shared-loss portion of provision for (recapture of) covered loan and lease losses, net | (1,984)                     | (13,860)         | 10,764                  | (10,659)         |
| <b>Balance at end of the period</b>   | <b>\$ 56,865</b>            | <b>\$ 37,240</b> | <b>\$ 56,865</b>        | <b>\$ 37,240</b> |

The Group's recorded investment in covered loan pools that have recorded impairments and their related allowance for covered loan and lease losses as of September 30, 2012 and December 31, 2011 are as follows:

|   | September 30, 2012 |                                    |                    |            |
|---|--------------------|------------------------------------|--------------------|------------|
|   | Unpaid Principal   | Recorded Investment (In thousands) | Specific Allowance | Coverage   |
| Impaired covered loan pools with specific allowance                       |                    |                                    |                    |            |
| Loans secured by 1-4 family residential properties                        | \$ 35,689          | \$ 24,025                          | \$ 4,700           | 20%        |
| Construction and development secured by 1-4 family residential properties | 75,641             | 7,668                              | 7,668              | 100%       |
| Commercial and other construction   | 187,108            | 84,906                             | 43,819             | 52%        |
| Consumer  | 16,490             | 10,859                             | 678                | 6%         |
| <b>Total investment in impaired covered loan pools</b>                    | <b>\$ 314,928</b>  | <b>\$ 127,458</b>                  | <b>\$ 56,865</b>   | <b>45%</b> |

December 31, 2011

|   | <b>Unpaid<br/>Principal</b> | <b>Recorded<br/>Investment<br/>(In thousands)</b> | <b>Specific<br/>Allowance</b> | <b>Coverage</b> |
|---|-----------------------------|---|-------------------------------|-----------------|
| Impaired covered loan pools with specific allowance                       |                             |   |                               |                 |
| Loans secured by 1-4 family residential properties                        | \$ 55,901                   | \$ 32,130   | \$ 1,657                      | 5%              |
| Construction and development secured by 1-4 family residential properties | 80,821                      | 16,976  | 2,042                         | 12%             |
| Commercial and other construction   | 357,596                     | 146,924   | 31,665                        | 22%             |
| Consumer  | 19,619                      | 13,778  | 1,892                         | 14%             |
| <b>Total investment in impaired covered loan pools</b>                    | <b>\$ 513,937</b>           | <b>\$ 209,808</b>                                 | <b>\$ 37,256</b>              | <b>18%</b>      |

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**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)****NOTE 6 - SERVICING ASSETS**

The Group periodically sells or securitizes mortgage loans while retaining the obligation to perform the servicing of such loans. In addition, the Group may purchase or assume the right to service mortgage loans originated by others. Whenever the Group undertakes an obligation to service a loan, management assesses whether a servicing asset and/or liability should be recognized. A servicing asset is recognized whenever the compensation for servicing is expected to more than adequately compensate the Group for servicing the loans and leases. Likewise, a servicing liability would be recognized in the event that servicing fees to be received are not expected to adequately compensate the Group for its expected cost.

All separately recognized servicing assets are recognized at fair value using the fair value measurement method. Under the fair value measurement method, the Group measures servicing rights at fair value at each reporting date, reports changes in fair value of servicing assets in earnings in the period in which the changes occur, and includes these changes, if any, with mortgage banking activities in the consolidated statements of operations. The fair value of servicing rights is subject to fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

The fair value of servicing rights is estimated by using a cash flow valuation model which calculates the present value of estimated future net servicing cash flows, taking into consideration actual and expected loan prepayment rates, discount rates, servicing costs, and other economic factors, which are determined based on current market conditions.

At September 30, 2012, servicing assets are composed of \$10.6 million (\$10.2 million — December 31, 2011) related to residential mortgage loans and \$80 thousand (\$221 thousand — December 31, 2011) of leasing servicing assets acquired in the FDIC-assisted acquisition of Eurobank.

The following table presents the changes in servicing rights measured using the fair value method for the quarters and nine-month periods ended September 30, 2012 and 2011:

|  | <b>Quarter Ended September 30,</b> |             | <b>Nine-Month Period Ended</b> |             |
|--|------------------------------------|-------------|--------------------------------|-------------|
|  | <b>2012</b>                        | <b>2011</b> | <b>September 30,</b>           | <b>2011</b> |
|  | <b>(In thousands)</b>              |             | <b>(In thousands)</b>          |             |
| <b>Fair value at beginning of period</b> | \$ 10,776                          | \$ 9,840    | \$ 10,454                      | \$ 9,695    |
|  | 487                                | 615         | 1,407                          | 1,828       |

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|   |                  |                  |                  |                  |  |
|---|------------------|------------------|------------------|------------------|--|
| Servicing from mortgage securitizations<br>or asset transfers |                  |                  |                  |                  |  |
| Changes due to payments on loans                              | (307)            | (225)            | (783)            | (705)            |  |
| Changes in fair value due to changes in<br>valuation model    |                  |                  |                  |                  |  |
| inputs or assumptions   | (314)            | (216)            | (436)            | (804)            |  |
| <b>Fair value at end of period</b>                            | <b>\$ 10,642</b> | <b>\$ 10,014</b> | <b>\$ 10,642</b> | <b>\$ 10,014</b> |  |

The following table presents key economic assumption ranges used in measuring the mortgage-related servicing asset fair value for the quarters and nine-month periods ended September 30, 2012 and 2011:

|                                 | Quarter Ended September 30, |                 | Nine-Month Period Ended September 30, |                 |
|---------------------------------|-----------------------------|-----------------|---------------------------------------|-----------------|
|                                 | 2012                        | 2011            | 2012                                  | 2011            |
| <b>Constant prepayment rate</b> | 9.43% - 15.80%              | 10.56% - 39.25% | 9.43% - 33.05%                        | 7.87% - 39.25%  |
| <b>Discount rate</b>            | 10.50% -<br>12.50%          | 11.00% - 14.00% | 10.50% -<br>13.50%                    | 11.00% - 14.00% |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table presents key economic assumption ranges used in measuring the leasing-related servicing asset fair value for the quarters and nine-month periods ended September 30, 2012 and 2011:

|                      | Quarter Ended September 30, |                 | Nine-Month Period Ended September 30, |                 |
|----------------------|-----------------------------|-----------------|---------------------------------------|-----------------|
|                      | 2012                        | 2011            | 2012                                  | 2011            |
| <b>Discount rate</b> | 13.27% -<br>15.14%          | 14.33% - 15.07% | 13.19% -<br>15.52%                    | 13.22% - 17.38% |

The sensitivity of the current fair value of servicing assets to immediate 10 percent and 20 percent adverse changes in the above key assumptions were as follows:

|   | <b>September 30,<br/>2012<br/>(In thousands)</b> |
|---|--|
| <b><u>Mortgage related servicing asset</u></b>    |  |
| <b>Carrying value of mortgage servicing asset</b> | \$ 10,562  |
| <b>Constant prepayment rate</b>                   |  |
| Decrease in fair value due to 10% adverse change  | \$ (452)   |
| Decrease in fair value due to 20% adverse change  | \$ (874)   |
| <b>Discount rate</b>                              |  |
| Decrease in fair value due to 10% adverse change  | \$ (441)   |
| Decrease in fair value due to 20% adverse change  | \$ (849)   |
| <b><u>Leasing servicing asset</u></b>             |  |
| <b>Carrying value of leasing servicing asset</b>  | \$ 80  |
| <b>Discount rate</b>                              |  |
| Decrease in fair value due to 10% adverse change  | \$ (1)   |
| Decrease in fair value due to 20% adverse change  | \$ (2)   |



**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption.

In reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments), which may magnify or offset the sensitivities. Mortgage banking activities, a component of total banking and wealth management revenues in the unaudited consolidated statements of operations, include the changes from period to period in the fair value of the mortgage loan servicing rights, which may result from changes in the valuation model inputs or assumptions (principally reflecting changes in discount rates and prepayment speed assumptions) and other changes, including changes due to collection/realization of expected cash flows.

Servicing fee income is based on a contractual percentage of the outstanding principal and is recorded as income when earned. Servicing fees on mortgage loans totaled \$920 thousand and \$806 thousand for the quarters ended September 30, 2012 and 2011, respectively. These fees totaled \$2.7 million and \$2.3 million for the nine-month periods ended September 30, 2012 and 2011, respectively. There were no late fees and ancillary fees recorded in such periods because these fees belong to the third party with which the Group is engaged in a subservicing agreement. Servicing fees on leases amounted to \$53 thousand and \$150 thousand for the quarters ended September 30, 2012 and 2011, respectively. These fees totaled \$200 thousand and \$549 thousand for the nine-month periods ended September 30, 2012 and 2011, respectively.

**NOTE 7 — PREMISES AND EQUIPMENT**

Premises and equipment at September 30, 2012 and December 31, 2011 are stated at cost less accumulated depreciation and amortization as follows:

|                            | Useful Life<br>(Years) | September 30,<br>2012 | December<br>31,<br>2011 |
|----------------------------|------------------------|-----------------------|-------------------------|
|                            |                        | (In thousands)        |                         |
| Land                       | —                      | \$ 2,254              | \$ 2,254                |
| Buildings and improvements | 40                     | 6,282                 | 5,890                   |
| Leasehold improvements     | 5 — 10                 | 18,289                | 18,182                  |
| Furniture and fixtures     | 3 — 7                  | 9,219                 | 9,718                   |

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|   |       |                  |                  |
|---|-------|------------------|------------------|
| Information technology and other                | 3 — 7 | 19,533           | 20,008           |
|   |       | 55,577           | 56,052           |
| Less: accumulated depreciation and amortization |       | (36,309)         | (34,532)         |
|   |       | <b>\$ 19,268</b> | <b>\$ 21,520</b> |

Depreciation and amortization of premises and equipment for the quarters ended September 30, 2012 and 2011 totaled \$1.1 million and \$1.4 million, respectively. For the nine-month periods ended September 30, 2012 and 2011, these expenses amounted to \$3.4 million and \$4.1 million, respectively. These are included in the unaudited consolidated statements of operations as part of occupancy and equipment expenses.

**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)****NOTE 8 — DERIVATIVE ACTIVITIES**

During the nine-month period ended September 30, 2012, losses of \$1.4 million were recognized and reflected as “Derivative Activities” in the unaudited consolidated statements of operations. These were mainly related to the amortization of premiums paid on options purchased in July 2012 to enter into interest rate swaps, not designated as cash flow hedges, with an aggregate notional amount of \$200.0 million. The amortization recorded during the quarter ended September 30, 2012, amounted to \$1.5 million. During the nine-month period ended September 30, 2011, losses of \$8.4 million were recognized and reflected as “Derivative Activities” in the unaudited consolidated statements of operations. These losses were mainly due to realized losses of \$4.3 million from terminations of forward-settlement swaps with a notional amount of \$1.25 billion, and to realized losses of \$2.2 million from terminations of options to enter into interest rate swaps with a notional amount of \$250 million.

The following table details “Derivative Assets” and “Derivative Liabilities” as reflected in the unaudited consolidated statements of financial condition at September 30, 2012 and December 31, 2011:

|  | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|--|-------------------------------|------------------------------|
|  | <b>(In thousands)</b>         |                              |
| Derivative assets:                               |                               |                              |
| Options tied to S&P 500 Index                    | \$ 13,088                     | \$ 9,317                     |
| Options on interest rate swaps                   | 5,407                         | -                            |
|  | <b>\$ 18,495</b>              | <b>\$ 9,317</b>              |
| Derivative liabilities:                          |                               |                              |
| Forward settlement swaps and interest rate swaps | \$ 58,269                     | \$ 47,425                    |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

*Forward-Settlement Swaps and Interest Rate Swaps*

The Group enters into forward-settlement swaps to hedge the variability of future interest cash flows of forecasted wholesale borrowings, attributable to changes in the one-month LIBOR rate. Once the forecasted wholesale borrowings transactions occur, the interest rate swap will effectively fix the Group's interest payments on an amount of forecasted interest expense attributable to the one-month LIBOR rate corresponding to the swap notional stated rate. These forward-settlement swaps are designated as cash flow hedges for the forecasted wholesale borrowings transactions and are properly documented as such, and therefore, qualify for cash flow hedge accounting. Changes in the fair value of these derivatives are recorded in accumulated other comprehensive income to the extent there is no significant ineffectiveness in the cash flow hedging relationships. Currently, the Group does not expect to reclassify any amount included in other comprehensive income related to these forward-settlement swaps to earnings in the next twelve months.

The following table shows a summary of these swaps and their terms at September 30, 2012:

| Type                     | Notional Amount<br>(In thousands) | Fixed Rate        | Trade Date | Settlement Date | Maturity Date |
|--------------------------|-----------------------------------|-------------------|------------|-----------------|---------------|
| Interest Rate Swaps      | \$ 100,000                        | 1.9275%           | 03/18/11   | 12/28/11        | 01/28/15      |
|                          | 100,000                           | 2.0000%           | 03/18/11   | 12/28/11        | 03/28/15      |
|                          | 100,000                           | 2.1100%           | 03/18/11   | 12/28/11        | 06/28/15      |
|                          | 25,000                            | 2.4365%           | 05/05/11   | 05/04/12        | 05/04/16      |
|                          | 125,000                           | 1.6550%           | 03/18/11   | 05/09/12        | 02/09/14      |
|                          | 125,000                           | 1.7700%           | 03/18/11   | 05/09/12        | 05/09/14      |
|                          | 100,000                           | 1.8975%           | 03/18/11   | 05/09/12        | 08/09/14      |
|                          | 25,000                            | 2.6200%           | 05/05/11   | 07/24/12        | 07/24/16      |
|                          | 25,000                            | 2.6350%           | 05/05/11   | 07/30/12        | 07/30/16      |
|                          | 50,000                            | 2.6590%           | 05/05/11   | 08/10/12        | 08/10/16      |
|                          | 100,000                           | 2.2225%           | 05/05/11   | 08/14/12        | 05/14/15      |
|                          | 100,000                           | 2.6750%           | 05/05/11   | 08/16/12        | 08/16/16      |
|                          |                                   | <b>\$ 975,000</b> |            |                 |               |
| Forward-Settlement Swaps | \$ 150,000                        | 2.7795%           | 05/05/11   | 12/06/12        | 06/06/16      |
|                          | <b>\$ 1,125,000</b>               |                   |            |                 |               |

An unrealized loss of \$58.3 million was recognized in accumulated other comprehensive income related to the valuation of these swaps at September 30, 2012, and the related liability is being reflected in the accompanying unaudited consolidated statements of financial condition.

**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)***Swap Options*

In July 2012, the Group purchased options to enter into interest rate swaps, not designated as cash flow hedges, with an aggregate notional amount of \$200 million. At September 30, 2012, the purchased options used to manage the exposure on the interest rate swaps represented an asset of \$5.4 million in the consolidated statements of financial position. The following table shows a summary of these swap options and their terms at September 30, 2012:

|    | <b>Notional<br/>Amount</b> | <b>Fixed<br/>Rate</b> | <b>Trade<br/>Date</b> | <b>Option<br/>Maturity Date</b> | <b>Swap<br/>Start Date</b> | <b>Swap<br/>Maturity<br/>Date</b> |
|----|----------------------------|-----------------------|-----------------------|---------------------------------|----------------------------|-----------------------------------|
|    | <b>(In thousands)</b>      |                       |                       |                                 |                            |                                   |
| \$ | 100,000                    | 2.2350%               | 07/06/12              | 07/07/14                        | 07/09/14                   | 07/09/24                          |
|    | 100,000                    | 1.8400%               | 07/06/12              | 01/07/13                        | 01/09/13                   | 01/09/23                          |
| \$ | <b>200,000</b>             |                       |                       |                                 |                            |                                   |

*Options Tied to Standard & Poor's 500 Stock Market Index*

The Group has offered its customers certificates of deposit with an option tied to the performance of the S&P 500 Index. The Group uses option agreements with major broker-dealer companies to manage its exposure to changes in this index. Under the terms of the option agreements, the Group receives the average increase in the month-end value of the index in exchange for a fixed premium. The changes in fair value of the option agreements used to manage the exposure in the stock market in the certificates of deposit are recorded in earnings. At September 30, 2012 and December 31, 2011, the purchased options used to manage the exposure to the S&P 500 Index on stock indexed deposits represented an asset of \$13.1 million (notional amount of \$72.2 million) and \$9.3 million (notional amount of \$130.0 million), respectively; the options sold to customers embedded in the certificates of deposit and recorded as deposits in the unaudited consolidated statements of financial condition, represented a liability of \$12.6 million (notional amount of \$67.6 million) and \$9.4 million (notional amount of \$125.8 million), respectively.

**NOTE 9 — ACCRUED INTEREST RECEIVABLE AND OTHER ASSETS**

Accrued interest receivable at September 30, 2012 and December 31, 2011 consists of the following:

|                   | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|-------------------|-------------------------------|------------------------------|
|                   | <b>(In thousands)</b>         |                              |
| Non-covered loans | \$ 5,588                      | \$ 5,519                     |
| Investments       | 9,347                         | 14,663                       |
|                   | <b>\$ 14,935</b>              | <b>\$ 20,182</b>             |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Other assets at September 30, 2012 and December 31, 2011 consist of the following:

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
|   | (In thousands)        |                      |
| Prepaid FDIC insurance  | \$ 7,705              | \$ 11,599            |
| Other prepaid expenses  | 11,047                | 6,498                |
| Servicing advances  | 9,041                 | 13,990               |
| Goodwill  | 2,701                 | 2,701                |
| Mortgage tax credits  | 1,303                 | 1,303                |
| Core deposit intangible   | 1,079                 | 1,185                |
| Investment in Statutory Trust                                     | 1,086                 | 1,086                |
| Debt issuance costs   | 822                   | 1,067                |
| Other repossessed assets (covered by FDIC shared-loss agreements) | 396                   | 708                  |
| Accounts receivable and other assets                              | 13,905                | 14,346               |
|   | <b>\$ 49,085</b>      | <b>\$ 54,483</b>     |

On November 12, 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, on December 31, 2009, along with each institution's risk-based deposit insurance assessment for the third quarter of 2009. The prepayment balance of the assessment covering fiscal years 2011 and 2012 amounted to \$7.7 million and \$11.6 million at September 30, 2012 and December 31, 2011, respectively.

Other prepaid expenses amounting to \$11.0 million and \$6.5 million at September 30, 2012 and December 31, 2011, respectively, include prepaid municipal, property and income taxes aggregating to \$7.8 million and \$3.2 million, respectively.

Servicing advances amounting to \$9.0 million and \$14.0 million at September 30, 2012 and December 31, 2011, respectively, represent the advances made to Bayview Loan Servicing, LLC in order to service some of the loans acquired in the FDIC-assisted acquisition of Eurobank.

In December 2007, the Commonwealth of Puerto Rico established mortgage loan tax credits for financial institutions that provided financing for the acquisition of new homes. Under an agreement reached during the quarter ended September 30, 2011 with the Puerto Rico Treasury Department, the Group was allowed to use half of these credits to



reduce taxable income in taxable year 2011, and the remaining half of the credits in taxable year 2012. At September 30, 2012 and December 31, 2011, tax credits for the Group amounted \$1.3 million for both periods.

As part of the FDIC-assisted acquisition of Eurobank, the Group registered a core deposit intangible representing the value of checking and savings deposits acquired. At September 30, 2012 and December 31, 2011, the core deposit intangible amounted to \$1.1 million and \$1.2 million, respectively. Also, as part of this transaction, the Group recorded a goodwill amounting to \$695 thousand.

Other repossessed assets amounting to \$396 thousand and \$708 thousand at September 30, 2012 and December 31, 2011, respectively, represent covered assets under the FDIC shared-loss agreements and are related to the leasing portfolio acquired in the FDIC-assisted acquisition of Eurobank.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

## NOTE 10 — DEPOSITS AND RELATED INTEREST

Total deposits as of September 30, 2012 and December 31, 2011 consist of the following:

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
|  | (In thousands)        |                      |
| Non-interest bearing demand deposits         | \$ 197,664            | \$ 192,256           |
| Interest-bearing savings and demand deposits | 1,101,698             | 1,081,447            |
| Individual retirement accounts               | 369,680               | 361,411              |
| Retail certificates of deposit               | 330,395               | 375,891              |
| Total retail deposits                        | 1,999,437             | 2,011,005            |
| Institutional deposits                       | 73,657                | 168,301              |
| Brokered deposits                            | 141,273               | 255,879              |
|  | <b>\$ 2,214,367</b>   | <b>\$ 2,435,185</b>  |

At September 30, 2012 and December 31, 2011, the weighted average interest rate of the Group's deposits was 1.32%, and 1.87%, respectively, inclusive of non-interest bearing deposits of \$197.7 million and \$192.3 million, respectively. Interest expense for the quarters and nine-month periods ended September 30, 2012 and 2011 is set forth below:

|                             | Quarter Ended September 30, |                  | Nine-Month Period Ended September 30, |                  |
|-----------------------------|-----------------------------|------------------|---------------------------------------|------------------|
|                             | 2012                        | 2011             | 2012                                  | 2011             |
|                             | (In thousands)              |                  | (In thousands)                        |                  |
| Demand and savings deposits | \$ 2,547                    | \$ 4,058         | \$ 8,571                              | \$ 12,683        |
| Certificates of deposit     | 4,761                       | 7,434            | 15,947                                | 22,638           |
|                             | <b>\$ 7,308</b>             | <b>\$ 11,492</b> | <b>\$ 24,518</b>                      | <b>\$ 35,321</b> |

At September 30, 2012 and December 31, 2011, demand and interest-bearing deposits and certificates of deposit included deposits of the Puerto Rico Cash & Money Market Fund, which amounted to \$87.2 million and \$64.9 million, respectively, with a weighted average rate of 0.77% and 0.82%, and were collateralized with investment securities with a fair value of \$72.3 million and \$62.7 million, respectively.

At September 30, 2012 and December 31, 2011, time deposits in denominations of \$100 thousand or higher, excluding unamortized discounts, amounted to \$335.1 million and \$456.1 million, including public fund time deposits from various Puerto Rico government agencies of \$195 thousand and \$65.2 million, respectively, at a weighted average rate of 0.5% in both periods.

At September 30, 2012 and December 31, 2011, public fund deposits from various Puerto Rico government agencies were collateralized with investment securities with a fair value of \$8.5 million and \$71.9 million, respectively, and with commercial loans amounting to \$2.3 million at September 30, 2012. There were no commercial loans pledged as collateral for public fund deposits at December 31, 2011.

**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

Excluding equity indexed options in the amount of \$12.6 million, which are used by the Group to manage its exposure to the S&P 500 Index, and also excluding accrued interest of \$2.3 million and unamortized deposit discounts in the amount of \$3.2 million, the scheduled maturities of certificates of deposit at September 30, 2012 are as follows:

|                              | <b>September<br/>30, 2012<br/>(In<br/>thousands)</b> |
|------------------------------|--|
| Within one year:             |  |
| Three (3) months or less     | \$ 167,688   |
| Over 3 months through 1 year | 372,340  |
|                              | 540,028  |
| Over 1 through 2 years       | 199,339  |
| Over 2 through 3 years       | 74,822   |
| Over 3 through 4 years       | 76,814   |
| Over 4 through 5 years       | 12,062   |
|                              | <b>\$ 903,065</b>                                    |

The aggregate amount of overdraft in demand deposit accounts that were reclassified to loans amounted to \$224 thousand and \$456 thousand as of September 30, 2012 and December 31, 2011, respectively.

**NOTE 11 — BORROWINGS*****Securities Sold under Agreements to Repurchase***

At September 30, 2012, securities underlying agreements to repurchase were delivered to, and are being held by, the counterparties with whom the repurchase agreements were transacted. The counterparties have agreed to resell to the Group the same or similar securities at the maturity of the agreements.

At September 30, 2012 and December 31, 2011, securities sold under agreements to repurchase (classified by counterparty), excluding accrued interest in the amount of \$2.4 million and \$6.2 million, respectively, were as follows:

|                                    | <b>September 30,<br/>2012</b> |   | <b>December 31,<br/>2011</b> |  |
|------------------------------------|-------------------------------|---|------------------------------|--|
|                                    | <b>Borrowing<br/>Balance</b>  | <b>Fair Value of<br/>Underlying<br/>Collateral<br/>(In thousands)</b> | <b>Borrowing<br/>Balance</b> | <b>Fair Value of<br/>Underlying<br/>Collateral</b> |
| Credit Suisse Securities (USA) LLC | \$ 1,250,000                  | \$ 1,299,180  | \$ 1,250,000                 | \$ 1,337,394                                       |
| UBS Financial Services Inc.        | 500,000                       | 621,614   | 500,000                      | 620,888  |
| Deutsche Bank                      | 225,000                       | 243,803   | 100,000                      | 109,177  |
| JP Morgan Chase Bank NA            | 200,000                       | 215,069   | 300,000                      | 357,400  |
| Citigroup Global Markets Inc.      | 150,000                       | 156,833   | 900,000                      | 974,286  |
| Goldman Sachs & Co.                | 125,000                       | 133,555   | -                            | -  |
| Barclays Bank                      | 100,000                       | 109,055   | -                            | -  |
| Wells Fargo                        | 100,000                       | 105,949   | -                            | -  |
| <b>Total</b>                       | <b>\$ 2,650,000</b>           | <b>\$ 2,885,058</b>   | <b>\$ 3,050,000</b>          | <b>\$ 3,399,145</b>                                |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The original terms of the Group's remaining structured repurchase agreements is ten years. For the repurchase agreements maturing in 2017 and amounting to \$1.750 billion as of September 30, 2012, the counterparties have the right to exercise put options on such structured repurchase agreements at par on a quarterly basis before their contractual maturities from one to three years after the agreements' settlement dates. The Group's \$500 million repurchase agreement maturing on March 2, 2017 also provides for an optional early termination by either party upon no less than two business days' prior written notice to the other party. In the event of any such optional early termination, the amounts owed by or to the terminating party by the other party on the optional early termination date must take account of the termination value of the transaction, as determined by the calculation agent in the manner described in the repurchase agreement. During the quarter ended September 30, 2012, the Group opted to terminate prior to maturity two repurchase agreements amounting to \$400 million. The early termination fee paid by the Group amounted to \$24.2 million and is presented in the statement of operations as a net loss on the early extinguishment of repurchase agreements for the quarter and nine-month period ended September 30, 2012.

The following table shows a summary of the Group's repurchase agreements and their terms, excluding accrued interest in the amount of \$2.4 million, at September 30, 2012:

| Year of Maturity | Borrowing<br>Balance<br>(In thousands) | Weighted-<br>Average<br>Coupon | Settlement Date | Maturity<br>Date | Next Put<br>Date |
|------------------|--|--------------------------------|-----------------|------------------|------------------|
| 2012             | \$ 100,000                             | 0.53%                          | 9/10/2012       | 10/9/2012        | N/A              |
|                  | 125,000                                | 0.39%                          | 9/10/2012       | 10/9/2012        | N/A              |
|                  | 125,000                                | 0.39%                          | 9/10/2012       | 10/9/2012        | N/A              |
|                  | 100,000                                | 0.41%                          | 9/14/2012       | 10/15/2012       | N/A              |
|                  | 150,000                                | 4.31%                          | 3/6/2007        | 12/6/2012        | N/A              |
|                  | 600,000                                |                                |                 |                  |                  |
| 2015             | 100,000                                | 0.51%                          | 12/28/2011      | 3/30/2015        | N/A              |
|                  | 100,000                                | 0.62%                          | 12/29/2011      | 1/28/2015        | N/A              |
|                  | 100,000                                | 0.56%                          | 12/28/2011      | 6/28/2015        | N/A              |
|                  | 300,000                                |                                |                 |                  |                  |
| 2017             | 500,000                                | 4.67%                          | 3/2/2007        | 3/2/2017         | 12/3/2012        |
|                  | 250,000                                | 0.25%                          | 3/2/2007        | 3/2/2017         | 12/3/2012        |
|                  | 100,000                                | 0.00%                          | 6/6/2007        | 3/6/2017         | 12/6/2012        |
|                  | 900,000                                | 0.00%                          | 3/6/2007        | 6/6/2017         | 12/6/2012        |
|                  | 1,750,000                              |                                |                 |                  |                  |
|                  | \$ 2,650,000                           | 1.28%                          |                 |                  |                  |

All of the structured repurchase agreements referred to above with maturity dates up to the date of this report were renewed as one-month short-term repurchase agreements.

Repurchase agreements include \$1.25 billion, which reset at each put date at a formula which is based on the three-month LIBOR rate less fifteen times the difference between the ten-year SWAP rate and the two-year SWAP rate, with a minimum of 0.00% on \$1.0 billion and 0.25% on \$250 million, and a maximum of 10.6%. These repurchase agreements bear the respective minimum rates of 0.00% and 0.25% to at least their next put dates scheduled for December 2012.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

*Advances from the Federal Home Loan Bank*

Advances are received from the FHLB under an agreement whereby the Group is required to maintain a minimum amount of qualifying collateral with a fair value of at least 110% of the outstanding advances. At September 30, 2012, these advances were secured by mortgage and commercial loans amounting to \$515.7 million and \$54.6 million, respectively. Also, at September 30, 2012, the Group had an additional borrowing capacity with the FHLB of \$155.6 million. At September 30, 2012 and December 31 2011, the weighted average remaining maturity of FHLB's advances was 5.0 months and 11.2 months, respectively. The original terms of these advances range between five and seven years, and the FHLB has the right to exercise put options at par on a quarterly basis before the contractual maturity of the advances from nine months to one year after the advances' settlement dates. The following table shows a summary of these advances and their terms, excluding accrued interest in the amount of \$382 thousand, at September 30, 2012:

| Year of Maturity | Borrowing Balance<br>(In thousands) | Weighted-Average Coupon | Settlement Date | Maturity Date | Next Put Date |
|------------------|-------------------------------------|-------------------------|-----------------|---------------|---------------|
| 2012             | \$ 25,000                           | 0.43%                   | 8/30/2012       | 10/1/2012     | N/A           |
|                  | 25,000                              | 0.41%                   | 9/4/2012        | 10/4/2012     | N/A           |
|                  | 25,000                              | 0.37%                   | 9/24/2012       | 10/24/2012    | N/A           |
|                  | 50,000                              | 0.41%                   | 9/10/2012       | 10/10/2012    | N/A           |
|                  | 100,000                             | 0.40%                   | 9/17/2012       | 10/16/2012    | N/A           |
|                  | 225,000                             |                         |                 |               |               |
| 2014             | 25,000                              | 4.20%                   | 5/8/2007        | 5/8/2014      | 11/8/2012     |
|                  | 30,000                              | 4.22%                   | 5/11/2007       | 5/11/2014     | 11/12/2012    |
|                  | 55,000                              |                         |                 |               |               |
| 2017             | 5,013                               | 1.24%                   | 4/3/2012        | 4/3/2017      | N/A           |
|                  | 5,013                               |                         |                 |               |               |
|                  | \$ 285,013                          | 1.15%                   |                 |               |               |

All of the advances referred to above with maturity dates up to the date of this report were renewed as one-month short-term advances.



***FDIC-Guaranteed Term Notes — Temporary Liquidity Guarantee Program***

On March 16, 2012, the Group's banking subsidiary repaid at maturity the \$105 million in senior unsecured notes that it issued in March 2009 under the FDIC's Temporary Liquidity Guarantee Program.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

*Subordinated Capital Notes*

Subordinated capital notes amounted to \$36.1 million at September 30, 2012 and December 31, 2011.

In August 2003, the Statutory Trust II, a special purpose entity of the Group, was formed for the purpose of issuing trust redeemable preferred securities. In September 2003, \$35.0 million of trust redeemable preferred securities were issued by the Statutory Trust II as part of a pooled underwriting transaction. Pooled underwriting involves participating with other bank holding companies in issuing the securities through a special purpose pooling vehicle created by the underwriters.

The proceeds from this issuance were used by the Statutory Trust II to purchase a like amount of floating rate junior subordinated deferrable interest debenture (“subordinated capital note”) issued by the Group. The subordinated capital note has a par value of \$36.1 million, bears interest based on 3-month LIBOR plus 295 basis points (3.34% at September 30, 2012; 3.30% at December 31, 2011), is payable quarterly, and matures on September 17, 2033. The subordinated capital note purchased by the Statutory Trust II may be called at par after five years and quarterly thereafter (next call date December 2012). The trust redeemable preferred securities have the same maturity and call provisions as the subordinated capital note. The subordinated deferrable interest debenture issued by the Group are accounted for as a liability denominated as subordinated capital note on the unaudited consolidated statements of financial condition.

The subordinated capital note is treated as Tier 1 capital for regulatory purposes. Under Federal Reserve Board rules, restricted core capital elements, which are qualifying trust preferred securities, qualifying cumulative perpetual preferred stock (and related surplus) and certain minority interests in consolidated subsidiaries, are limited in the aggregate to no more than 25% of a bank holding company’s core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability. However, under the Dodd-Frank Act, bank holding companies are prohibited from including in their Tier 1 capital hybrid debt and equity securities, including trust preferred securities, issued on or after May 19, 2010. Any such instruments issued before May 19, 2010 by a bank holding company, such as the Group, with total consolidated assets of less than \$15 billion as of December 31, 2009, may continue to be included as Tier 1 capital. Therefore, the Group is permitted to continue to include its existing trust preferred securities as Tier 1 capital.

**NOTE 12 — RELATED PARTY TRANSACTIONS**

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The Bank grants loans to its directors, executive officers and to certain related individuals or organizations in the ordinary course of business. These loans are offered at the same terms as loans to unrelated third parties. As of September 30, 2012 and December 31, 2011, these loans balances amounted to \$5.0 million and \$3.8 million, respectively. The activity and balance of these loans for the quarters and nine-month periods ended September 30, 2012 and 2011 were as follows:

|   | Quarter Ended September 30, |                 | Nine-Month Period Ended September 30, |                 |
|---|-----------------------------|-----------------|---------------------------------------|-----------------|
|   | 2012                        | 2011            | 2012                                  | 2011            |
|   | (In thousands)              |                 | (In thousands)                        |                 |
| <b>Balance at the beginning of period</b>               | \$ 5,058                    | \$ 3,213        | \$ 3,772                              | \$ 3,452        |
| New loans   | -                           | 582             | 1,396                                 | 582             |
| Repayments  | (17)                        | 15              | (93)                                  | (37)            |
| Credits of persons no longer considered related parties | (23)                        | -               | (57)                                  | (187)           |
| <b>Balance at the end of period</b>                     | \$ <b>5,018</b>             | \$ <b>3,810</b> | \$ <b>5,018</b>                       | \$ <b>3,810</b> |

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

**NOTE 13 — INCOME TAXES**

At September 30, 2012 and December 31, 2011, the Group's net deferred tax asset amounted to \$35.9 million and \$32.0 million, respectively. Income tax expense for the quarters ended September 30, 2012 and 2011 totaled of \$1.9 million and \$580 thousand, respectively. Income tax expense for the nine-month periods ended September 30, 2012 and 2011 totaled \$4.9 million and \$5.7 million, respectively.

At December 31, 2011, OIB had \$2.9 million in the income tax effect of unrecognized gain on available-for-sale securities included in other comprehensive income. Following the change in OIB's applicable tax rate from 5% to 0% as a result of new Puerto Rico legislation adopted in 2011, this remaining tax balance will flow through income as these securities are repaid or sold in future periods. During the quarter and nine-month period ended September 30, 2012, the income tax provision included \$1.1 million and \$1.8 million, respectively, related to this residual tax effect from OIB.

The Group classifies unrecognized tax benefits in income taxes payable. These gross unrecognized tax benefits would affect the effective tax rate if realized. The balance of unrecognized tax benefits at September 30, 2012 was \$1.5 million (December 31, 2011 - \$1.4 million). The Group had accrued \$768 thousand at September 30, 2012 (December 31, 2011 - \$342 thousand) for the payment of interest and penalties relating to unrecognized tax benefits.

**NOTE 14 — STOCKHOLDERS' EQUITY**

***Regulatory Capital Requirements***

The Group (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Group's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Group and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. This has changed under the Dodd-Frank Act, which requires federal banking regulators to establish minimum leverage and risk-based capital requirements, on a consolidated basis, for insured institutions, depository institutions, depository institution holding companies, and non-bank financial companies supervised by the Federal Reserve Board. The minimum leverage and risk-based capital requirements are

to be determined based on the minimum ratios established for insured depository institutions under prompt corrective action regulations.

Quantitative measures established by regulation to ensure capital adequacy require the Group and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations) and of Tier 1 capital to average assets (as defined in the regulations). As of September 30, 2012 and December 31, 2011, the Group and the Bank met all capital adequacy requirements to which they are subject. As of September 30, 2012 and December 31, 2011, the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Group's and the Bank's actual capital amounts and ratios as of September 30, 2012 and December 31, 2011 are as follows:

|  | Actual     |        | Minimum Capital Requirement |       |
|--|------------|--------|-----------------------------|-------|
|  | Amount     | Ratio  | Amount                      | Ratio |
| (Dollars in thousands)                 |            |        |                             |       |
| <b>Group Ratios</b>                    |            |        |                             |       |
| <b><u>As of September 30, 2012</u></b> |            |        |                             |       |
| Total capital to risk-weighted assets  | \$ 711,987 | 37.63% | \$ 151,362                  | 8.00% |
| Tier 1 capital to risk-weighted assets | \$ 687,436 | 36.33% | \$ 75,681                   | 4.00% |
| Tier 1 capital to total assets         | \$ 687,436 | 10.91% | \$ 252,145                  | 4.00% |
| <b><u>As of December 31, 2011</u></b>  |            |        |                             |       |
| Total capital to risk-weighted assets  | \$ 688,188 | 33.12% | \$ 167,929                  | 8.00% |
| Tier 1 capital to risk-weighted assets | \$ 661,614 | 31.84% | \$ 83,964                   | 4.00% |
| Tier 1 capital to total assets         | \$ 661,614 | 9.65%  | \$ 274,230                  | 4.00% |

|  | Actual     |        | Minimum Capital Requirement |       | Minimum to be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|------------|--------|-----------------------------|-------|--|--------|
|  | Amount     | Ratio  | Amount                      | Ratio | Amount   | Ratio  |
| (Dollars in thousands)                 |            |        |                             |       |  |        |
| <b>Bank Ratios</b>                     |            |        |                             |       |  |        |
| <b><u>As of September 30, 2012</u></b> |            |        |                             |       |  |        |
| Total capital to risk-weighted assets  | \$ 685,032 | 36.77% | \$ 149,049                  | 8.00% | \$ 186,311   | 10.00% |
| Tier 1 capital to risk-weighted assets | \$ 660,838 | 35.47% | \$ 74,525                   | 4.00% | \$ 111,787   | 6.00%  |
| Tier 1 capital to total assets         | \$ 660,838 | 10.66% | \$ 247,862                  | 4.00% | \$ 309,827   | 5.00%  |
| <b><u>As of December 31, 2011</u></b>  |            |        |                             |       |  |        |
| Total capital to risk-weighted assets  | \$ 643,065 | 31.07% | \$ 165,573                  | 8.00% | \$ 206,967   | 10.00% |
| Tier 1 capital to risk-weighted assets | \$ 616,590 | 29.79% | \$ 82,787                   | 4.00% | \$ 124,180   | 6.00%  |
|  | \$ 616,590 | 9.06%  | \$ 272,177                  | 4.00% | \$ 340,221   | 5.00%  |

Tier 1 capital to total  
assets

The Group's ability to pay dividends to its shareholders and other activities can be restricted if its capital falls below levels established by the Federal Reserve Board's guidelines. In addition, any bank holding company whose capital falls below levels specified in the guidelines can be required to implement a plan to increase capital.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

*Equity-Based Compensation Plan*

The Omnibus Plan provides for equity-based compensation incentives through the grant of stock options, stock appreciation rights, restricted stock, restricted stock units, and dividend equivalents, as well as equity-based performance awards. The Omnibus Plan replaced and superseded the Stock Option Plans. All outstanding stock options under the Stock Option Plans continue in full force and effect, subject to their original terms.

The activity in outstanding options for the nine-month periods ended September 30, 2012 and 2011 is set forth below:

|                            | Nine-Month Period Ended September 30,<br>2012 |  | 2011                    |  |
|----------------------------|---|--|-------------------------|--|
|                            | Number<br>Of<br>Options                       | Weighted<br>Average<br>Exercise<br>Price | Number<br>Of<br>Options | Weighted<br>Average<br>Exercise<br>Price |
| <b>Beginning of period</b> | 786,704                                       | \$ 15.02                                 | 765,989                 | \$ 15.25                                 |
| Options granted            | 204,543                                       | 11.83                                    | 85,000                  | 11.90                                    |
| Options exercised          | (32,954)                                      | 11.98                                    | (550)                   | 9.19                                     |
| Options forfeited          | (23,500)                                      | 11.93                                    | (33,142)                | 14.82                                    |
| <b>End of period</b>       | <b>934,793</b>                                | <b>\$ 14.51</b>                          | <b>817,297</b>          | <b>\$ 14.89</b>                          |

The following table summarizes the range of exercise prices and the weighted average remaining contractual life of the options outstanding at September 30, 2012:

| <u>Range of Exercise Prices</u> | Outstanding          |  | Weighted<br>Average<br>Contract<br>Life<br>Remaining<br>(Years) | Exercisable          |  |
|---------------------------------|----------------------|--|---|----------------------|--|
|                                 | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price |   | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price |
| \$5.63 to \$8.45                | 12,432               | \$ 8.28                                  | 6.6   | 5,885                | \$ 8.28                                  |
| 8.46 to 11.27                   | 1,000                | 10.29                                    | 4.9   | 750                  | 10.29                                    |



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|                                  |                  |                 |            |                  |                 |
|----------------------------------|------------------|-----------------|------------|------------------|-----------------|
| 11.28 to 14.09                   | 691,876          | 12.06           | 7.3        | 196,933          | 12.39           |
| 14.10 to 16.90                   | 62,035           | 15.60           | 1.9        | 62,035           | 15.60           |
| 19.72 to 22.54                   | 25,050           | 20.68           | 2.4        | 22,925           | 20.57           |
| 22.55 to 25.35                   | 83,350           | 23.99           | 1.5        | 83,350           | 23.99           |
| 25.36 to 28.17                   | 59,050           | 27.46           | 2.1        | 59,050           | 27.46           |
|                                  | <b>934,793</b>   | <b>\$ 14.51</b> | <b>6.0</b> | <b>430,928</b>   | <b>\$ 17.53</b> |
| <b>Aggregate Intrinsic Value</b> | <b>\$ 28,078</b> |                 |            | <b>\$ 13,355</b> |                 |

The average fair value of each option granted during the nine-month period ended September 30, 2012 was \$5.41. The average fair value of each option granted was estimated at the date of the grant using the Black-Scholes option pricing model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no restrictions and are fully transferable and negotiable in a free trading market. Black-Scholes does not consider the employment, transfer or vesting restrictions that are inherent in the Group's stock options. Use of an option valuation model, as required by GAAP, includes highly subjective assumptions based on long-term predictions, including the expected stock price volatility and average life of each option grant.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following assumptions were used in estimating the fair value of the options granted during the nine-month periods ended September 30, 2012 and 2011:

|                               | Nine-Month Period Ended September 30, |        |
|-------------------------------|---------------------------------------|--------|
|                               | 2012                                  | 2011   |
| Weighted average assumptions: |                                       |        |
| Dividend yield                | 1.80%                                 | 1.63%  |
| Expected volatility           | 51.13%                                | 59.04% |
| Risk-free interest rate       | 1.70%                                 | 3.11%  |
| Expected life (in years)      | 8.0                                   | 8.0    |

The following table summarizes the restricted units' activity under the Omnibus Plan for the nine-month periods ended September 30, 2012 and 2011:

|                            | Nine-Month Period Ended September 30, |   |                     |   |
|----------------------------|---------------------------------------|---|---------------------|---|
|                            | 2012                                  |   | 2011                |   |
|                            | Restricted<br>Units                   | Weighted<br>Average<br>Grant Date<br>Fair Value | Restricted<br>Units | Weighted<br>Average<br>Grant Date<br>Fair Value |
| <b>Beginning of period</b> | 205,149                               | \$ 11.27  | 243,525             | \$ 13.43  |
| Restricted units granted   | 57,350                                | 11.85   | 39,500              | 11.88   |
| Restricted units lapsed    | (46,210)                              | 8.29  | (51,116)            | 20.44   |
| Restricted units forfeited | (2,789)                               | 11.71   | (14,620)            | 12.21   |
| <b>End of period</b>       | <b>213,500</b>                        | <b>\$ 12.06</b>                                 | <b>217,289</b>      | <b>\$ 11.67</b>                                 |

*Preferred Stock*

In connection with the BBVAPR Acquisition, as discussed in Note 1, on July 3, 2012, the Group completed its sale to various institutional purchasers of \$84 million of its Convertible Preferred Stock, with a conversion price, subject to certain conditions, of \$11.77 per share of common stock, through a private placement, pursuant to a Subscription Agreement dated June 28, 2012, between the Group and each of the purchasers.

***Additional paid-in capital***

Additional paid-in capital represents contributed capital in excess of par value of common and preferred stock net of costs of the issuance. During the quarter ended September 30, 2012, \$4.9 million of preferred stock issue costs were charged against additional paid-in capital. As of September 30, 2012, accumulated issuance costs charged against additional paid in capital amounted to \$7.6 million and \$9.2 million for preferred and common stock, respectively.

***Legal Surplus***

The Puerto Rico Banking Act requires that a minimum of 10% of the Bank's net income for the year be transferred to a reserve fund until such fund (legal surplus) equals the total paid in capital on common and preferred stock. At September 30, 2012 and December 31, 2011, legal surplus amounted to \$54.4 million and \$50.2 million, respectively. The amount transferred to the legal surplus account is not available for the payment of dividends to shareholders.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

*Earnings per Common Share*

The calculation of earnings per common share for the quarters and nine-month periods ended September 30, 2012 and 2011 is as follows:

|  | Quarter Ended September 30,           |               | Nine-Month Period Ended |                  |                  |
|--|---------------------------------------|---------------|-------------------------|------------------|------------------|
|  | 2012                                  | 2011          | 2012                    | 2011             |                  |
|  | (In thousands, except per share data) |               |                         |                  |                  |
| <b>Net income</b>  | \$                                    | 17,761        | \$ 16,788               | \$ 43,371        | \$ 46,336        |
| Less: Dividends on preferred stock   |                                       |               |                         |                  |                  |
| Non-convertible preferred stock (Series A and B)                                   |                                       | (1,201)       | (1,201)                 | (3,602)          | (3,602)          |
| Convertible Preferred Stock (Series C)   |                                       | (1,838)       | -                       | (1,838)          | -                |
| <b>Income available to common shareholders</b>                                     | \$                                    | <b>14,722</b> | \$ <b>15,587</b>        | \$ <b>37,931</b> | \$ <b>42,734</b> |
| Effect of assumed conversion of the Convertible Preferred Stock                    |                                       | 1,838         | -                       | 1,838            | -                |
| <b>Income available to common shareholders assuming conversion</b>                 | \$                                    | <b>16,560</b> | \$ <b>15,587</b>        | \$ <b>39,769</b> | \$ <b>42,734</b> |
| <br>   |                                       |               |                         |                  |                  |
| <b>Weighted average common shares and share equivalents:</b>                       |                                       |               |                         |                  |                  |
| Average common shares outstanding  |                                       | 40,738        | 44,015                  | 40,828           | 45,050           |
| Effect of dilutive securities:   |                                       |               |                         |                  |                  |
| Average potential common shares-options  |                                       | 102           | 90                      | 109              | 91               |
| Average potential common shares-assuming conversion of Convertible Preferred Stock |                                       | 7,138         | -                       | 2,379            | -                |
| <b>Total weighted average common shares</b>  |                                       |               |                         |                  |                  |

|  |    |               |    |               |    |               |    |               |
|--|----|---------------|----|---------------|----|---------------|----|---------------|
| <b>outstanding and equivalents</b>         |    | <b>47,978</b> |    | <b>44,105</b> |    | <b>43,316</b> |    | <b>45,141</b> |
| <b>Earnings per common share - basic</b>   | \$ | <b>0.36</b>   | \$ | <b>0.35</b>   | \$ | <b>0.93</b>   | \$ | <b>0.95</b>   |
| <b>Earnings per common share - diluted</b> | \$ | <b>0.35</b>   | \$ | <b>0.35</b>   | \$ | <b>0.92</b>   | \$ | <b>0.95</b>   |

In computing diluted earnings per common share, the 84,000 shares of Convertible Preferred Stock, which remained outstanding at September 30, 2012, with a conversion rate, subject to certain conditions, of 84.9798 shares of common stock per share, were included as average potential common shares from the date they were outstanding. Moreover, in computing diluted earnings per common share, the dividends declared during the quarter ended September 30, 2012 on the Convertible Preferred Stock were added back as income available to common shareholders.

For the quarters ended September 30, 2012 and 2011, weighted-average stock options with an anti-dilutive effect on earnings per share not included in the calculation amounted to 708,976 and 572,284, respectively. For the nine-month periods ended September 30, 2012 and 2011, weighted-average stock options with an anti-dilutive effect on earnings per share not included in the calculation amounted to 707,976 and 558,193, respectively.

### *Treasury Stock*

On February 3, 2011, the Group announced that its Board of Directors had approved a stock repurchase program pursuant to which the Group was authorized to purchase in the open market up to \$30 million of its outstanding shares of common stock. On June 29, 2011, the Group announced the completion of the \$30 million stock repurchase program and the approval by the Board of Directors of a new program to purchase an additional \$70 million of common stock in the open market.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Any shares of common stock repurchased are held by the Group as treasury shares. The Group records treasury stock purchases under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock. Under the \$30 million program, initiated in February 2011, the Group purchased a total of 2,406,303 shares at an average price of \$12.10 per share. During 2011, the Group purchased approximately 2,783,000 shares under the \$70 million program for a total of \$29.4 million, at an average price of \$10.57 per share. During the nine-month period ended September 30, 2012, the Group purchased approximately 603,000 additional shares under this program for a total of \$7.0 million, at an average price of \$11.61 per share.

The activity in connection with common shares held in treasury by the Group for the nine-month periods ended September 30, 2012 and 2011 is set forth below:

|   | Nine-Month Period Ended September 30,<br>2012 |                  | 2011             |                  |
|---|---|------------------|------------------|------------------|
|   | Shares  | Dollar<br>Amount | Shares           | Dollar<br>Amount |
|   | (In thousands, except shares data)            |                  |                  |                  |
| Beginning of period   | 6,564,124                                     | \$ 74,808        | 1,459,067        | \$ 16,732        |
| Common shares used upon lapsing of restricted stock units         | (46,210)                                      | (483)            | (51,116)         | (561)            |
| Common shares repurchased as part of the stock repurchase program | 603,000                                       | 7,022            | 2,406,303        | 29,242           |
| Common shares used to match defined contribution plan, net        | (25,249)                                      | (47)             | (20,761)         | (37)             |
| <b>End of period</b>  | <b>7,095,665</b>                              | <b>\$ 81,300</b> | <b>3,793,493</b> | <b>\$ 45,376</b> |

*Accumulated Other Comprehensive Income*

Accumulated other comprehensive income, net of income tax, as of September 30, 2012 and December 31, 2011 consisted of:

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
|  | (In thousands)        |                      |
| Unrealized gain on securities available-for-sale which are not | \$ 64,921             | \$ 86,404            |

|   |              |               |
|---|--------------|---------------|
| other-than-temporarily impaired                                       |              |               |
| Income tax effect of unrealized gain on securities available-for-sale | (4,823)      | (7,160)       |
| Unrealized loss on cash flow hedges                                   | (58,269)     | (47,425)      |
| Income tax effect of unrealized loss on cash flow hedges              | 7,234        | 5,312         |
|   | \$           | \$            |
|   | <b>9,063</b> | <b>37,131</b> |

At December 31, 2011, OIB had \$2.9 million in the income tax effect of unrecognized gain on available-for-sale securities included in other comprehensive income. Following the change in OIB's applicable tax rate from 5% to 0% as a result of new Puerto Rico legislation adopted in 2011, this remaining tax balance will flow through income as these securities are repaid or sold in future periods. During the nine-month period ended September 30, 2012, \$1.8 million related to this residual tax effect from OIB were reclassified from accumulated other comprehensive income into income tax provision.

**ORIENTAL FINANCIAL GROUP INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)****NOTE 15 — COMMITMENTS***Loan Commitments*

At September 30, 2012 and December 31, 2011, there were \$135.4 million and \$106.1 million, respectively, in loan commitments, which represent unused lines of credit and letters of credit provided to customers. These lines of credit had a reserve of \$603 thousand and \$518 thousand at September 30, 2012 and December 31, 2011, respectively. Commitments to extend credit are agreements to lend to customers as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates, bear variable interest and may require payment of a fee. Since the commitments may expire unexercised, the total commitment amounts do not necessarily represent future cash requirements. The Group evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Group upon the extension of credit, is based on management's credit evaluation of the customer. Commitments for loans covered under the FDIC shared-loss agreements amounted to \$14.1 million and \$31.1 million at September 30, 2012 and December 31, 2011, respectively.

At September 30, 2012 and December 31, 2011, commitments to sell or securitize mortgage loans amounted to approximately \$39.3 million and \$66.1 million, respectively.

*Lease Commitments*

The Group has entered into various operating lease agreements for branch facilities and administrative offices. Rent expense for the quarters ended September 30, 2012 and 2011 amounted to \$1.6 million and 1.5 million, respectively. Rent expense for the nine-month periods ended September 30, 2012 and 2011 amounted to \$4.9 million and \$3.0 million, respectively. Both are included in the "occupancy and equipment" caption in the unaudited consolidated statements of operations. Future rental commitments under leases in effect at September 30, 2012, exclusive of taxes, insurance, and maintenance expenses payable by the Group, are summarized as follows:

| <b><u>Year Ending December 31,</u></b> |    | <b>Minimum Rent<br/>(In thousands)</b> |
|--|----|--|
| 2012                                   | \$ | 1,142                                  |
| 2013                                   |    | 4,572                                  |
| 2014                                   |    | 4,569                                  |
| 2015                                   |    | 4,323                                  |
| 2016                                   |    | 3,741                                  |



Thereafter

17,341

\$

**35,688**

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

**NOTE 16 — CONTINGENCIES**

The Group and its subsidiaries are defendants in a number of legal proceedings incidental to their business. In the ordinary course of business, the Group and its subsidiaries are also subject to governmental and regulatory examinations. Certain subsidiaries of the Group, including the Bank, Oriental Financial Services, and Oriental Insurance, are subject to regulation by various U.S., Puerto Rico and other regulators.

The Group seeks to resolve all litigation and regulatory matters in the manner management believes is in the best interests of the Group and its shareholders, and contests allegations of liability or wrongdoing and, where applicable, the amount of damages or scope of any penalties or other relief sought as appropriate in each pending matter.

Subject to the accounting and disclosure framework under the provisions of ASC 450, it is the opinion of the Group's management, based on current knowledge and after taking into account its current legal accruals, that the eventual outcome of all matters would not be likely to have a material adverse effect on the unaudited consolidated financial condition of the Group. Nonetheless, given the substantial or indeterminate amounts sought in certain of these matters, and the inherent unpredictability of such matters, an adverse outcome in certain of these matters could, from time to time, have a material adverse effect on the Group's unaudited consolidated results of operations or cash flows in particular quarterly or annual periods. The Group has evaluated all litigation and regulatory matters where the likelihood of a potential loss is deemed reasonably possible. The Group has determined that the estimate of the reasonably possible loss is not significant.

**NOTE 17 - FAIR VALUE**

As discussed in Note 1, the Group follows the fair value measurement framework under GAAP.

***Fair Value Measurement***

The fair value measurement framework defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This framework also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs previously described that may be used

to measure fair value.

***Money market investments***

The fair value of money market investments is based on the carrying amounts reflected in the unaudited consolidated statements of financial condition as these are reasonable estimates of fair value given the short-term nature of the instruments.

***Investment securities***

The fair value of investment securities is based on quoted market prices, when available, or market prices provided by recognized broker-dealers. If listed prices or quotes are not available, fair value is based upon externally developed models that use both observable and unobservable inputs depending on the market activity of the instrument. Structured credit investments are classified as Level 3. The estimated fair value of the structured credit investments are determined by using a third-party cash flow valuation model to calculate the present value of projected future cash flows. The assumptions, which are highly uncertain and require a high degree of judgment, include primarily market discount rates, current spreads, duration, leverage, default, home price depreciation, and loss rates. The assumptions used are drawn from a wide array of data sources, including the performance of the collateral underlying each deal. The external-based valuation, which is obtained at least on a quarterly basis, is analyzed and its assumptions are evaluated and incorporated in either an internal-based valuation model when deemed necessary or compared to counterparties' prices, and agreed by management.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

*Derivative instruments*

The fair value of the forward-starting interest rate swaps and options on interest rate swaps is largely a function of the financial market's expectations regarding the future direction of interest rates. Accordingly, current market values are not necessarily indicative of the future impact of derivative instruments on earnings. This will depend, for the most part, on the shape of the yield curve, the level of interest rates, as well as the expectations for rates in the future. The fair value of most of these derivative instruments is based on observable market parameters, which include discounting the instruments' cash flows using the U.S. dollar LIBOR-based discount rates, and also applying yield curves that account for the industry sector and the credit rating of the counterparty and/or the Group.

Certain other derivative instruments with limited market activity are valued using externally developed models that consider unobservable market parameters. Based on their valuation methodology, derivative instruments are classified as Level 3. The Group has offered its customers certificates of deposit with an option tied to the performance of the S&P Index and uses equity indexed option agreements with major broker-dealer companies to manage its exposure to changes in this index. Their fair value is obtained through the use of an external based valuation that was thoroughly evaluated and adopted by management as its measurement tool for these options. The payoff of these options is linked to the average value of the S&P Index on a specific set of dates during the life of the option. The methodology uses an average rate option or a cash-settled option whose payoff is based on the difference between the expected average value of the S&P Index during the remaining life of the option and the strike price at inception. The assumptions, which are uncertain and require a degree of judgment, include primarily S&P Index volatility, forward interest rate projections, estimated index dividend payout, and leverage.

*Servicing assets*

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

*Loans receivable considered impaired that are collateral dependent*

The impairment is measured based on the fair value of the collateral, which is derived from appraisals that take into consideration prices in observed transactions involving similar assets in similar locations, in accordance with the provisions of ASC 310-10-35. Currently, the associated loans considered impaired are classified as Level 3.

***Foreclosed real estate***

Foreclosed real estate includes real estate properties securing residential mortgage and commercial loans. The fair value of foreclosed real estate may be determined using an external appraisal, broker price option or an internal valuation. These foreclosed assets are classified as Level 3 given certain internal adjustments that may be made to external appraisals.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Assets and liabilities measured at fair value on a recurring and non-recurring basis, including financial liabilities for which the Group has elected the fair value option, are summarized below:

|  |                | <b>September 30, 2012</b>      |                     |                  |           |                  |
|--|----------------|--------------------------------|---------------------|------------------|-----------|------------------|
|  |                | <b>Fair Value Measurements</b> |                     |                  |           |                  |
|  | <b>Level 1</b> | <b>Level 2</b>                 | <b>Level 3</b>      | <b>Total</b>     |           |                  |
|  |                | <b>(In thousands)</b>          |                     |                  |           |                  |
| Recurring fair value measurements:     |                |                                |                     |                  |           |                  |
| Investment securities                  |                |                                |                     |                  |           |                  |
| available-for-sale                     | \$             | -                              | \$ 2,254,531        | \$ 39,019        | \$        | 2,293,550        |
| Securities purchased under             |                |                                |                     |                  |           |                  |
| agreements to resell                   |                | -                              | 270,000             | -                |           | 270,000          |
| Money market investments               |                | 4,017                          | -                   | -                |           | 4,017            |
| Derivative assets                      |                | -                              | 5,407               | 13,088           |           | 18,495           |
| Servicing assets                       |                | -                              | -                   | 10,642           |           | 10,642           |
| Derivative liabilities                 |                | -                              | (58,269)            | (12,569)         |           | (70,838)         |
|  | <b>\$</b>      | <b>4,017</b>                   | <b>\$ 2,471,669</b> | <b>\$ 50,180</b> | <b>\$</b> | <b>2,525,866</b> |
| Non-recurring fair value measurements: |                |                                |                     |                  |           |                  |
| Impaired commercial loans              | \$             | -                              | -                   | \$ 35,917        | \$        | 35,917           |
| Foreclosed real estate                 |                | -                              | -                   | 39,400           |           | 39,400           |
|  | <b>\$</b>      | <b>-</b>                       | <b>\$ -</b>         | <b>\$ 75,317</b> | <b>\$</b> | <b>75,317</b>    |
|  |                | <b>December 31, 2011</b>       |                     |                  |           |                  |
|  |                | <b>Fair Value Measurements</b> |                     |                  |           |                  |
|  | <b>Level 1</b> | <b>Level 2</b>                 | <b>Level 3</b>      | <b>Total</b>     |           |                  |
|  |                | <b>(In thousands)</b>          |                     |                  |           |                  |
| Recurring fair value measurements:     |                |                                |                     |                  |           |                  |
| Investment securities                  |                |                                |                     |                  |           |                  |
| available-for-sale                     | \$             | -                              | \$ 2,912,600        | \$ 47,312        | \$        | 2,959,912        |
| Money market investments               |                | 3,863                          | -                   | -                |           | 3,863            |
| Derivative assets                      |                | -                              | -                   | 9,317            |           | 9,317            |
| Servicing assets                       |                | -                              | -                   | 10,454           |           | 10,454           |
| Derivative liabilities                 |                | -                              | (47,425)            | (9,362)          |           | (56,787)         |
|  | <b>\$</b>      | <b>3,863</b>                   | <b>\$ 2,865,175</b> | <b>\$ 57,721</b> | <b>\$</b> | <b>2,926,759</b> |
| Non-recurring fair value measurements: |                |                                |                     |                  |           |                  |
| Impaired commercial loans              | \$             | -                              | -                   | \$ 46,364        | \$        | 46,364           |
| Foreclosed real estate                 |                | -                              | -                   | 27,679           |           | 27,679           |
|  | <b>\$</b>      | <b>-</b>                       | <b>\$ -</b>         | <b>\$ 74,043</b> | <b>\$</b> | <b>74,043</b>    |







| <b>Level 3<br/>Instruments Only</b>  | <b>CDOs</b> | <b>CLOs</b> | <b>Other<br/>debt</b>                | <b>Derivative<br/>asset<br/>(S&amp;P<br/>Purchased<br/>Options)</b> | <b>Servicing<br/>assets</b> | <b>Derivative<br/>liability<br/>(S&amp;P<br/>Embedded<br/>Options)</b> | <b>Total</b> |
|--|-------------|-------------|--------------------------------------|---|-----------------------------|--|--------------|
|  |             |             | <b>securities<br/>(In thousands)</b> |   |                             |  |              |
| Balance at beginning of period   | \$ 17,484   | \$ 28,229   | \$ 10,068                            | \$ 11,925   | \$ 9,840                    | \$ (12,877)  | \$ 64,669    |
| Gains (losses) included in earnings  | -           | -           | -                                    | (5,272)   | -                           | 4,459  | (813)        |
| Changes in fair value of investment securities available for sale included in other comprehensive income | (1,951)     | (2,965)     | 10                                   | -   | -                           | -  | (4,906)      |
| New instruments acquired   | -           | -           | -                                    | 54  | 615                         | 1,183  | 1,852        |
| Amortization   | -           | 179         | (1)                                  | -   | (225)                       | -  | (47)         |
| Changes in fair value of servicing assets  | -           | -           | -                                    | -   | (216)                       | -  | (216)        |
| Balance at end of period   | \$ 15,533   | \$ 25,443   | \$ 10,077                            | \$ 6,707  | \$ 10,014                   | \$ (7,235)   | \$ 60,539    |

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

## Nine-Month Period Ended September 30, 2012

## Investment securities available-for-sale

| Level 3<br>Instruments<br>Only   | CDOs      | CLOs      | Other<br>debt | Derivative                | Derivative                    | Servicing<br>assets | Derivative | Total |
|--|-----------|-----------|---------------|---------------------------|-------------------------------|---------------------|------------|-------|
|  |           |           |               | asset<br>(S&P<br>Options) | liability<br>(S&P<br>Options) |                     |            |       |
| (In thousands)   |           |           |               |                           |                               |                     |            |       |
| Balance at beginning of period   | \$ 10,530 | \$ 26,758 | \$ 10,024     | \$ 9,317                  | \$ 10,454                     | \$ (9,362)          | \$ 57,721  |       |
| Gains (losses) included in earnings  | -         | -         | -             | 3,771                     | -                             | (3,742)             | 29         |       |
| Changes in fair value of investment securities available for sale included in other comprehensive income | -         | 2,193     | (6)           | -                         | -                             | -                   | 2,187      |       |
| New instruments acquired   | -         | -         | -             | -                         | 1,407                         | -                   | 1,407      |       |
| Principal repayments   | -         | -         | -             | -                         | (783)                         | -                   | (783)      |       |
| Amortization   | -         | 51        | (1)           | -                         | -                             | 535                 | 585        |       |
| Sales of instruments   | (10,530)  | -         | -             | -                         | -                             | -                   | (10,530)   |       |
| Changes in fair value of servicing assets  | -         | -         | -             | -                         | (436)                         | -                   | (436)      |       |
| Balance at end of period   | \$ -      | \$ 29,002 | \$ 10,017     | \$ 13,088                 | \$ 10,642                     | \$ (12,569)         | \$ 50,180  |       |

## Nine-Month Period Ended September 30, 2011

**Investment securities available-for-sale**

| <b>Level 3<br/>Instruments Only</b>  | <b>CDOs</b> | <b>CLOs</b> | <b>Other<br/>debt<br/>securities<br/>(In thousands)</b> | <b>Derivative<br/>asset<br/>(S&amp;P<br/>Purchased<br/>Options)</b> | <b>Servicing<br/>assets</b> | <b>Derivative<br/>liability<br/>(S&amp;P<br/>Embedded<br/>Options)</b> | <b>Total</b> |
|--|-------------|-------------|---|---|-----------------------------|--|--------------|
| Balance at beginning of period   | \$ 16,143   | \$ 25,550   | \$ -  | \$ 9,870  | \$ 9,695                    | \$ (12,830)  | \$ 48,428    |
| Gains (losses) included in earnings  | -           | -           | -   | (3,587)   | -                           | 3,175  | (412)        |
| Changes in fair value of investment securities available for sale included in other comprehensive income | (610)       | (287)       | 75  | -   | -                           | -  | (822)        |
| New instruments acquired   | -           | -           | 10,005  | 424   | 1,828                       | 482  | 12,739       |
| Principal repayments   | -           | -           | -   | -   | (705)                       | -  | (705)        |
| Amortization   | -           | 180         | (3)   | -   | -                           | 1,938  | 2,115        |
| Changes in fair value of servicing assets  | -           | -           | -   | -   | (804)                       | -  | (804)        |
| Balance at end of period   | \$ 15,533   | \$ 25,443   | \$ 10,077   | \$ 6,707  | \$ 10,014                   | \$ (7,235)   | \$ 60,539    |

There were purchases and sales of assets and liabilities measured at fair value on a recurring basis. There were no transfers into and out of Level 1 and Level 2 fair value measurements during the quarters and nine-month periods ended September 30, 2012 and 2011.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The table below presents quantitative information for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) at September 30, 2012:

|   |                       |          | <b>September 30, 2012</b> |   |  |
|---|-----------------------|----------|---------------------------|---|--|
|   | <b>Fair Value</b>     |          | <b>Valuation</b>          | <b>Unobservable</b>   | <b>Range</b>   |
|   | <b>(In thousands)</b> |          | <b>Technique</b>          | <b>Input</b>  |  |
| Investment securities                       |                       |          |                           |   |  |
| available-for-sale:                         |                       |          |                           |   |  |
| CLOs  | \$                    | 29,002   | Discounted cash flow      | Prepayment rate<br>Probability of default<br>Loss severity                                | 0% static<br>0% - 25%<br>100%  |
| Other debt securities                       | \$                    | 10,017   | Market comparable bonds   | Indicative pricing<br>Option adjusted spread<br>Yield to maturity<br>Spread to maturity   | 101.9% - 107.2%<br>132.1% - 225.9%<br>1.6% - 2.6%<br>131.7% - 225.6% |
| Derivative asset (S&P Purchased Options)    | \$                    | 13,088   | Option pricing model      | Implied option volatility<br>Counterparty credit risk<br><br>(based on 5-year CDS spread) | 11.9% - 35.7%<br><br><br>122.1% - 232.7%                             |
| Servicing assets                            | \$                    | 10,642   | Cash flow valuation       | Constant prepayment rate<br>Discount rate   | 9.43% - 33.05%<br>10.50% - 13.50%                                    |
| Derivative liability (S&P Embedded Options) | \$                    | (12,569) | Option pricing model      | Implied option volatility   | 11.9% - 35.7%  |

|   |                 |
|---|-----------------|
| Counterparty credit risk (based on 5-year CDS spread) | 122.1% - 232.7% |
|---|-----------------|

### *Information about Sensitivity to Changes in Significant Unobservable Inputs*

**CLOs** – The significant unobservable inputs used in the fair value measurement of the Group’s CLOs are prepayment rates, probability of default, and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally, although not equally proportional, opposite change in the assumption used for prepayment rates.

**Other debt securities** – The significant unobservable inputs used in the fair value measurement of one of the Group’s other debt securities are indicative comparable pricing, option adjusted spread (“OAS”), yield to maturity, and spread to maturity. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for indicative comparable pricing is accompanied by a directionally opposite change in the assumption used for OAS and a directionally, although not equally proportional, opposite change in the assumptions used for yield to maturity and spread to maturity.

**Derivative asset (S&P Purchased Options)** – The significant unobservable inputs used in the fair value measurement of Group’s derivative assets related to S&P purchased options are implied option volatility and counterparty credit risk. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for implied option volatility is not necessarily accompanied by directionally similar or opposite changes in the assumption used for counterparty credit risk.

**Servicing assets** – The significant unobservable inputs used in the fair value measurement of the Group’s servicing assets are constant prepayment rates and discount rates. Changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments), which may magnify or offset the sensitivities. Mortgage banking activities, a component of total banking and wealth management revenues in the unaudited consolidated statements of operations, include the changes from period to period in the fair value of the mortgage loan servicing rights, which may result from changes in the valuation model inputs or assumptions (principally reflecting changes in discount rates and prepayment speed assumptions) and other changes, including changes due to collection/realization of expected cash flows.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Derivative liability (S&P Embedded Options) – The significant unobservable inputs used in the fair value measurement of the Group’s derivative liability related to S&P purchased options are implied option volatility and counterparty credit risk. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for implied option volatility is not necessarily accompanied by directionally similar or opposite changes in the assumption used for counterparty credit risk.

The table below presents a detail of investment securities available-for-sale classified as Level 3 at September 30, 2012:

| <u>Type</u>                          | September 30, 2012 |                                 |                |                |    | Weighted<br>Average<br>Yield | Principal<br>Protection |        |
|--------------------------------------|--------------------|---------------------------------|----------------|----------------|----|------------------------------|-------------------------|--------|
|                                      | Amortized<br>Cost  | Unrealized<br>Gains<br>(Losses) | Fair Value     |                |    |                              |                         |        |
|                                      |                    |                                 | (In thousands) |                |    |                              |                         |        |
| <b>Other debt securities</b>         | \$                 | 10,000                          | \$             | 17             | \$ | 10,017                       | 3.50%                   | N/A    |
| <b>Structured credit investments</b> |                    |                                 |                |                |    |                              |                         |        |
| CLO                                  |                    | 15,000                          |                | (3,174)        |    | 11,826                       | 2.59%                   | 7.54%  |
| CLO                                  |                    | 11,980                          |                | (2,418)        |    | 9,562                        | 2.01%                   | 26.18% |
| CLO                                  |                    | 9,444                           |                | (1,830)        |    | 7,614                        | 1.46%                   | 20.64% |
|                                      |                    | 36,424                          |                | (7,422)        |    | 29,002                       | 2.12%                   |        |
| <b>Total</b>                         | \$                 | <b>46,424</b>                   | \$             | <b>(7,405)</b> | \$ | <b>39,019</b>                | <b>2.42%</b>            |        |

*Fair Value of Financial Instruments*

The information about the estimated fair value of financial instruments required by GAAP is presented hereunder. The aggregate fair value amounts presented do not necessarily represent management’s estimate of the underlying value of the Group.

The estimated fair value is subjective in nature, involves uncertainties and matters of significant judgment, and therefore, cannot be determined with precision. Changes in assumptions could affect these fair value estimates. The fair value estimates do not take into consideration the value of future business and the value of assets and liabilities that are not financial instruments. Other significant tangible and intangible assets that are not considered financial

instruments are the value of long-term customer relationships of the retail deposits, and premises and equipment.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The estimated fair value and carrying value of the Group's financial instruments at September 30, 2012 and December 31, 2011 is as follows:

|  | September 30,<br>2012 |                   | December 31,<br>2011 |                   |
|--|-----------------------|-------------------|----------------------|-------------------|
|  | Fair<br>Value         | Carrying<br>Value | Fair<br>Value        | Carrying<br>Value |
|  | (In thousands)        |                   |                      |                   |
| <b>Level 1</b>                                     |                       |                   |                      |                   |
| <b>Financial Assets:</b>                           |                       |                   |                      |                   |
| Cash and cash equivalents                          | \$ 515,495            | \$ 515,495        | \$ 591,487           | \$ 591,487        |
| <b>Level 2</b>                                     |                       |                   |                      |                   |
| <b>Financial Assets:</b>                           |                       |                   |                      |                   |
| Securities purchased under<br>agreements to resell | 270,000               | 270,000           | -                    | -                 |
| Trading securities                                 | 1,514                 | 1,514             | 180                  | 180               |
| Investment securities<br>available-for-sale        | 2,254,531             | 2,254,531         | 2,912,600            | 2,912,600         |
| Investment securities<br>held-to-maturity          | 874,921               | 835,084           | 904,556              | 884,026           |
| Federal Home Loan Bank<br>(FHLB) stock             | 22,865                | 22,865            | 23,779               | 23,779            |
| Derivative assets                                  | 5,407                 | 5,407             | -                    | -                 |
| <b>Financial Liabilities:</b>                      |                       |                   |                      |                   |
| Derivative liabilities                             | 58,269                | 58,269            | 47,425               | 47,425            |
| <b>Level 3</b>                                     |                       |                   |                      |                   |
| <b>Financial Assets:</b>                           |                       |                   |                      |                   |
| Investment securities<br>available-for-sale        | 39,019                | 39,019            | 47,312               | 47,312            |
| Total loans (including loans<br>held-for-sale)     |                       |                   |                      |                   |
| Non-covered loans, net                             | 1,199,806             | 1,182,730         | 1,211,539            | 1,169,917         |
| Covered loans, net                                 | 512,344               | 413,588           | 584,110              | 496,276           |
| Derivative assets                                  | 13,088                | 13,088            | 9,317                | 9,317             |
| FDIC shared-loss<br>indemnification asset          | 216,394               | 328,573           | 312,957              | 392,367           |
| Accrued interest receivable                        | 14,935                | 14,935            | 20,182               | 20,182            |
| Servicing assets                                   | 10,642                | 10,642            | 10,454               | 10,454            |
| <b>Financial Liabilities:</b>                      |                       |                   |                      |                   |
| Deposits   | 2,323,831             | 2,214,367         | 2,567,352            | 2,435,185         |
| Securities sold under<br>agreements to repurchase  | 2,702,122             | 2,652,366         | 3,092,122            | 3,056,238         |



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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Advances from FHLB                     | 287,616 | 285,395 | 285,663 | 281,753 |
| FDIC-guaranteed term notes             | -       | -       | 105,752 | 105,834 |
| Subordinated capital notes             | 36,464  | 36,083  | 36,235  | 36,083  |
| Accrued expenses and other liabilities | 33,038  | 33,038  | 35,602  | 35,602  |

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**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

The following methods and assumptions were used to estimate the fair values of significant financial instruments at September 30, 2012 and December 31, 2011:

- Cash and cash equivalents (including money market investments and time deposits with other banks), accrued interest receivable, securities purchased under agreements to resell, accrued expenses and other liabilities have been valued at the carrying amounts reflected in the unaudited consolidated statements of financial condition as these are reasonable estimates of fair value given the short-term nature of the instruments.
- Investments in FHLB stock are valued at their redemption value.
- The fair value of investment securities, including trading securities, is based on quoted market prices, when available, or market prices provided by recognized broker dealers. If listed prices or quotes are not available, fair value is based upon externally developed models that use both observable and unobservable inputs depending on the market activity of the instrument. The estimated fair value of the structured credit investments is determined by using a third-party cash flow valuation model to calculate the present value of projected future cash flows. The assumptions used, which are highly uncertain and require a high degree of judgment, include primarily market discount rates, current spreads, duration, leverage, default, home price depreciation, and loss rates. The assumptions used are drawn from a wide array of data sources, including the performance of the collateral underlying each deal. The external-based valuation, which is obtained at least on a quarterly basis, is analyzed and its assumptions are evaluated and incorporated in either an internal-based valuation model when deemed necessary, or compared to counterparties' prices and agreed by management.
- The fair value of the FDIC shared-loss indemnification asset represents the present value of the estimated cash payments (net of amounts owed to the FDIC) expected to be received from the FDIC for future losses on covered assets based on the credit assumptions on estimated cash flows for each covered asset pool and the loss sharing percentages. The ultimate collectability of the FDIC shared-loss indemnification asset is dependent upon the performance of the underlying covered loans, the passage of time and claims paid by the FDIC which are impacted by the Bank's adherence to certain guidelines established by the FDIC.
- The fair value of servicing assets is estimated by using a cash flow valuation model which calculates the present value of estimated future net servicing cash flows, taking into consideration actual and expected loan prepayment rates, discount rates, servicing costs, and other economic factors, which are determined based on current market conditions.

- The fair values of the derivative instruments are provided by valuation experts and counterparties. Certain derivatives with limited market activity are valued using externally developed models that consider unobservable market parameters. The Group has offered its customers certificates of deposit with an option tied to the performance of the S&P Index, and uses equity indexed option agreements with major broker-dealer companies to manage its exposure to changes in this index. Their fair value is obtained through the use of an external based valuation that was thoroughly evaluated and adopted by management as its measurement tool for these options. The payoff of these options is linked to the average value of the S&P Index on a specific set of dates during the life of the option. The methodology uses an average rate option or a cash-settled option whose payoff is based on the difference between the expected average value of the S&P Index during the remaining life of the option and the strike price at inception. The assumptions, which are uncertain and require a degree of judgment, include primarily S&P Index volatility, forward interest rate projections, estimated index dividend payout, and leverage.
- Fair value of derivative liabilities, which include interest rate swaps and forward-settlement swaps, are based on the net discounted value of the contractual projected cash flows of both the pay-fixed receive-variable legs of the contracts. The projected cash flows are based on the forward yield curve, and discounted using current estimated market rates.
- The fair value of the covered and non-covered loan portfolio (including loans held-for-sale) is estimated by segregating by type, such as mortgage, commercial, consumer, and leasing. Each loan segment is further segmented into fixed and adjustable interest rates and by performing and non-performing categories. The fair value of performing loans is calculated by discounting contractual cash flows, adjusted for prepayment estimates (voluntary and involuntary), if any, using estimated current market discount rates that reflect the credit and interest rate risk inherent in the loan. This fair value is not currently an indication of an exit price as that type of assumption could result in a different fair value estimate.
- The fair value of demand deposits and savings accounts is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is based on the discounted value of the contractual cash flows, using estimated current market discount rates for deposits of similar remaining maturities.

**ORIENTAL FINANCIAL GROUP INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

- The fair value of long-term borrowings, which include securities sold under agreements to repurchase, advances from FHLB, FDIC-guaranteed term notes, and subordinated capital notes is based on the discounted value of the contractual cash flows using current estimated market discount rates for borrowings with similar terms, remaining maturities and put dates.
- The fair value of commitments to extend credit and unused lines of credit is based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings.

**NOTE 18 - SEGMENT REPORTING**

The Group segregates its businesses into the following major reportable segments of business: Banking, Wealth Management, and Treasury. Management established the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. Other factors such as the Group's organization, nature of its products, distribution channels and economic characteristics of the products were also considered in the determination of the reportable segments. The Group measures the performance of these reportable segments based on pre-established goals of different financial parameters such as net income, net interest income, loan production, and fees generated. The Group's methodology for allocating non-interest expenses among segments is based on several factors such as revenues, employee headcount, occupied space, dedicated services or time, among others. These factors are reviewed on a periodical basis and may change if the conditions warrant.

Banking includes the Bank's branches and mortgage banking, with traditional banking products such as deposits and mortgage, commercial and consumer loans. Mortgage banking activities are carried out by the Bank's mortgage banking division, whose principal activity is to originate mortgage loans for the Group's own portfolio. As part of its mortgage banking activities, the Group may sell loans directly into the secondary market or securitize conforming loans into mortgage-backed securities.

Wealth Management is comprised of the Bank's trust division, Oriental Financial Services, Oriental Insurance, and CPC. The core operations of this segment are financial planning, money management and investment banking, brokerage services, insurance sales activity, corporate and individual trust and retirement services, as well as pension plan administration services.

The Treasury segment encompasses all of the Group's asset/liability management activities such as: purchases and sales of investment securities, interest rate risk management, derivatives, and borrowings. Intersegment sales and

transfers, if any, are accounted for as if the sales or transfers were to third parties, that is, at current market prices. The accounting policies of the segments are the same as those described in the “Summary of Significant Accounting Policies” included in the Group’s Annual Report on Form 10-K.

## ORIENTAL FINANCIAL GROUP INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Following are the results of operations and the selected financial information by operating segment as of and for the quarters and nine-month periods ended September 30, 2012 and 2011:

|  | Quarter Ended September 30, 2012 |                      |                     |                         |                     | Consolidated<br>Total |
|--|----------------------------------|----------------------|---------------------|-------------------------|---------------------|-----------------------|
|  | Banking                          | Wealth<br>Management | Treasury            | Total Major<br>Segments | Eliminations        |                       |
|  | (In thousands)                   |                      |                     |                         |                     |                       |
| Interest income \$                               | 40,247                           | \$ -                 | \$ 25,439           | \$ 65,686               | \$ -                | \$ 65,686             |
| Interest expense                                 | (5,328)                          | -                    | (20,155)            | (25,483)                | -                   | (25,483)              |
| Net interest income                              | 34,919                           | -                    | 5,284               | 40,203                  | -                   | 40,203                |
| Provision for non-covered loan and lease losses  | (3,600)                          | -                    | -                   | (3,600)                 | -                   | (3,600)               |
| Provision for covered loan and lease losses, net | (221)                            | -                    | -                   | (221)                   | -                   | (221)                 |
| Non-interest income (loss)                       | (3,130)                          | 6,072                | 10,710              | 13,652                  | -                   | 13,652                |
| Non-interest expenses                            | (22,980)                         | (2,540)              | (4,859)             | (30,379)                | -                   | (30,379)              |
| Intersegment revenues                            | 343                              | -                    | -                   | 343                     | (343)               | -                     |
| Intersegment expenses                            | -                                | (265)                | (78)                | (343)                   | 343                 | -                     |
| <b>Income before income taxes</b> \$             | <b>5,331</b>                     | <b>\$ 3,267</b>      | <b>\$ 11,057</b>    | <b>\$ 19,655</b>        | <b>\$ -</b>         | <b>\$ 19,655</b>      |
| <b>Total assets</b> \$                           | <b>3,157,147</b>                 | <b>\$ 16,370</b>     | <b>\$ 3,590,836</b> | <b>\$ 6,764,353</b>     | <b>\$ (713,148)</b> | <b>\$ 6,051,205</b>   |

|   | Quarter Ended September 30, 2011 |                      |           |                         |              | Consolidated<br>Total |
|---|----------------------------------|----------------------|-----------|-------------------------|--------------|-----------------------|
|   | Banking                          | Wealth<br>Management | Treasury  | Total Major<br>Segments | Eliminations |                       |
|   | (In thousands)                   |                      |           |                         |              |                       |
| Interest income \$                              | 35,383                           | \$ -                 | \$ 36,153 | \$ 71,536               | \$ -         | \$ 71,536             |
| Interest expense                                | (8,247)                          | -                    | (30,819)  | (39,066)                | -            | (39,066)              |
| Net interest income                             | 27,136                           | -                    | 5,334     | 32,470                  | -            | 32,470                |
| Provision for non-covered loan and lease losses | (3,800)                          | -                    | -         | (3,800)                 | -            | (3,800)               |

|   |                     |                  |                     |                     |                     |                     |
|---|---------------------|------------------|---------------------|---------------------|---------------------|---------------------|
| Recapture of covered loan and lease losses, net | 1,936               | -                | -                   | 1,936               | -                   | <b>1,936</b>        |
| Non-interest income                             | 3,065               | 5,503            | 8,397               | 16,965              | -                   | <b>16,965</b>       |
| Non-interest expenses                           | (22,899)            | (4,167)          | (3,137)             | (30,203)            | -                   | <b>(30,203)</b>     |
| Intersegment revenues                           | 319                 | -                | -                   | 319                 | (319)               | -                   |
| Intersegment expenses                           | -                   | (202)            | (117)               | (319)               | 319                 | -                   |
| <b>Income (loss) before income taxes</b>        | <b>\$ 5,757</b>     | <b>\$ 1,134</b>  | <b>\$ 10,477</b>    | <b>\$ 17,368</b>    | <b>\$ -</b>         | <b>\$ 17,368</b>    |
| <b>Total assets</b>                             | <b>\$ 3,236,344</b> | <b>\$ 14,361</b> | <b>\$ 4,464,861</b> | <b>\$ 7,715,566</b> | <b>\$ (692,278)</b> | <b>\$ 7,023,288</b> |





|                                   |                 |                 |                  |                  |             |                  |
|-----------------------------------|-----------------|-----------------|------------------|------------------|-------------|------------------|
| Intersegment revenues             | 1,042           | -               | -                | 1,042            | (1,042)     | -                |
| Intersegment expenses             | -               | (708)           | (334)            | (1,042)          | 1,042       | -                |
| <b>Income before income taxes</b> | <b>\$ 6,579</b> | <b>\$ 1,809</b> | <b>\$ 43,609</b> | <b>\$ 51,997</b> | <b>\$ -</b> | <b>\$ 51,997</b> |

**NOTE 19 – SUBSEQUENT EVENTS**

On October 31, 2012 the Group sold 4,829,267 shares of its common stock at a public offering price of \$11.10 and a purchase price of \$10.66 per share in a registered public offering.

On November 5, 2012 the Group sold 960,000 shares of its 7.125% Non-Cumulative Perpetual Preferred Stock, Series D (the “Series D Preferred Stock”) at a public offering price of \$25 and a purchase price of \$24 per share in a registered public offering.

## Item 2 — MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### SELECTED FINANCIAL DATA

|  | Quarter Ended September 30, |                  |               | Nine-Month Period Ended September 30, |                  |               |
|--|-----------------------------|------------------|---------------|---------------------------------------|------------------|---------------|
|  | 2012                        | 2011             | Variance %    | 2012                                  | 2011             | Variance %    |
| <b>EARNINGS DATA:</b>  |                             |                  |               |                                       |                  |               |
| (In thousands, except per share data)                                |                             |                  |               |                                       |                  |               |
| Interest income  | \$ 65,686                   | \$ 71,536        | -8.2%         | \$ 196,393                            | \$ 231,772       | -15.3%        |
| Interest expense   | 25,483                      | 39,066           | -34.8%        | 84,251                                | 119,214          | -29.3%        |
| <b>Net interest income</b>   | <b>40,203</b>               | <b>32,470</b>    | <b>23.8%</b>  | <b>112,142</b>                        | <b>112,558</b>   | <b>-0.4%</b>  |
| Provision for non-covered loan and lease losses                      | 3,600                       | 3,800            | -5.3%         | 10,400                                | 11,400           | -8.8%         |
| Provision for (recapture of) covered loan and lease losses, net      | 221                         | (1,936)          | 111.4%        | 8,845                                 | (1,387)          | 737.7%        |
| <b>Total provision for loan and lease losses, net</b>                | <b>3,821</b>                | <b>1,864</b>     | <b>105.0%</b> | <b>19,245</b>                         | <b>10,013</b>    | <b>92.2%</b>  |
| <b>Net interest income after provision for loan and lease losses</b> | <b>36,382</b>               | <b>30,606</b>    | <b>18.9%</b>  | <b>92,897</b>                         | <b>102,545</b>   | <b>-9.4%</b>  |
| Non-interest income  | 13,652                      | 16,965           | -19.5%        | 43,368                                | 40,700           | 6.6%          |
| Non-interest expenses  | 30,379                      | 30,203           | 0.6%          | 88,006                                | 91,248           | -3.6%         |
| <b>Income before taxes</b>   | <b>19,655</b>               | <b>17,368</b>    | <b>13.2%</b>  | <b>48,259</b>                         | <b>51,997</b>    | <b>-7.2%</b>  |
| Income tax expense   | 1,894                       | 580              | 226.6%        | 4,888                                 | 5,661            | -13.7%        |
| <b>Net Income</b>  | <b>17,761</b>               | <b>16,788</b>    | <b>5.8%</b>   | <b>43,371</b>                         | <b>46,336</b>    | <b>-6.4%</b>  |
| Less: dividends on preferred stock                                   | (3,039)                     | (1,201)          | 153.0%        | (5,440)                               | (3,602)          | 51.0%         |
| <b>Income available to common shareholders</b>                       | <b>\$ 14,722</b>            | <b>\$ 15,587</b> | <b>-5.5%</b>  | <b>\$ 37,931</b>                      | <b>\$ 42,734</b> | <b>-11.2%</b> |
| <b>PER SHARE DATA:</b>   |                             |                  |               |                                       |                  |               |
| <b>Basic</b>   | <b>\$ 0.36</b>              | <b>\$ 0.35</b>   | <b>2.1%</b>   | <b>\$ 0.93</b>                        | <b>\$ 0.95</b>   | <b>-2.1%</b>  |
| <b>Diluted</b>   | <b>\$ 0.35</b>              | <b>\$ 0.35</b>   | <b>-2.3%</b>  | <b>\$ 0.92</b>                        | <b>\$ 0.95</b>   | <b>-3.0%</b>  |

|  |                 |               |                 |                 |               |              |
|--|-----------------|---------------|-----------------|-----------------|---------------|--------------|
| <b>Average common shares outstanding</b>                 | <b>40,738</b>   | <b>44,015</b> | <b>-7.4%</b>    | <b>40,828</b>   | <b>45,050</b> | <b>-9.4%</b> |
| <b>Average common shares outstanding and equivalents</b> | <b>47,978</b>   | <b>44,105</b> | <b>8.8%</b>     | <b>43,316</b>   | <b>45,141</b> | <b>-4.0%</b> |
| <b>Book value per common share</b> \$                    | <b>15.40</b> \$ | <b>15.05</b>  | <b>2.3%</b> \$  | <b>15.40</b> \$ | <b>15.05</b>  | <b>2.3%</b>  |
| <b>Tangible book value per common share</b> \$           | <b>15.30</b> \$ | <b>14.96</b>  | <b>2.3%</b> \$  | <b>15.30</b> \$ | <b>14.96</b>  | <b>2.3%</b>  |
| <b>Market price at end of period</b> \$                  | <b>10.52</b> \$ | <b>9.67</b>   | <b>8.8%</b> \$  | <b>10.52</b> \$ | <b>9.67</b>   | <b>8.8%</b>  |
| <b>Cash dividends declared per common share</b> \$       | <b>0.06</b> \$  | <b>0.05</b>   | <b>20.0%</b> \$ | <b>0.18</b> \$  | <b>0.15</b>   | <b>20.0%</b> |
| <b>Cash dividends declared on common shares</b> \$       | <b>2,445</b> \$ | <b>2,202</b>  | <b>11.0%</b> \$ | <b>7,331</b> \$ | <b>6,677</b>  | <b>9.8%</b>  |
| <b>PERFORMANCE RATIOS:</b>                               |                 |               |                 |                 |               |              |
| <b>Return on average assets (ROA)</b>                    | <b>1.11%</b>    | <b>0.95%</b>  | <b>16.7%</b>    | <b>0.89%</b>    | <b>0.86%</b>  | <b>4.0%</b>  |
| <b>Return on average common equity (ROE)</b>             | <b>9.27%</b>    | <b>9.41%</b>  | <b>-1.5%</b>    | <b>8.01%</b>    | <b>8.65%</b>  | <b>-7.3%</b> |
| <b>Equity-to-assets ratio</b>                            | <b>12.75%</b>   | <b>10.36%</b> | <b>23.0%</b>    | <b>12.75%</b>   | <b>10.36%</b> | <b>23.0%</b> |
| <b>Efficiency ratio</b>                                  | <b>59.04%</b>   | <b>69.30%</b> | <b>-14.8%</b>   | <b>60.13%</b>   | <b>63.49%</b> | <b>-5.3%</b> |
| <b>Expense ratio</b>                                     | <b>1.32%</b>    | <b>1.19%</b>  | <b>10.6%</b>    | <b>1.22%</b>    | <b>1.23%</b>  | <b>-0.9%</b> |
| <b>Interest rate spread</b>                              | <b>2.69%</b>    | <b>1.97%</b>  | <b>36.7%</b>    | <b>2.48%</b>    | <b>2.27%</b>  | <b>9.3%</b>  |
| <b>Interest rate margin</b>                              | <b>2.77%</b>    | <b>2.03%</b>  | <b>36.4%</b>    | <b>2.55%</b>    | <b>2.31%</b>  | <b>10.4%</b> |

**SELECTED FINANCIAL DATA - (Continued)**

|   | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> | <b>Variance<br/>%</b> |
|---|-------------------------------|------------------------------|-----------------------|
| <b>PERIOD END BALANCES AND CAPITAL RATIOS:</b>      |                               |                              |                       |
| <b>Investments and loans</b>                        |                               |                              |                       |
| Investments securities                              | \$ 3,153,082                  | \$ 3,867,970                 | -18.5%                |
| Loans and leases not covered under shared-loss      |                               |                              |                       |
| agreements with the FDIC, net                       | 1,182,730                     | 1,169,917                    | 1.1%                  |
| Loans and leases covered under shared-loss          |                               |                              |                       |
| agreements with the FDIC, net                       | 413,588                       | 496,276                      | -16.7%                |
| <b>Total investments and loans</b>                  | <b>\$ 4,749,400</b>           | <b>\$ 5,534,163</b>          | <b>-14.2%</b>         |
| <b>Deposits and borrowings</b>                      |                               |                              |                       |
| Deposits  | \$ 2,214,367                  | \$ 2,435,185                 | -9.1%                 |
| Securities sold under agreements to repurchase      | 2,652,366                     | 3,056,238                    | -13.2%                |
| Other borrowings                                    | 321,478                       | 423,670                      | -24.1%                |
| <b>Total deposits and borrowings</b>                | <b>\$ 5,188,211</b>           | <b>\$ 5,915,093</b>          | <b>-12.3%</b>         |
| <b>Stockholders' equity</b>                         |                               |                              |                       |
| Preferred stock                                     | \$ 152,000                    | \$ 68,000                    | 123.5%                |
| Common stock  | 47,842                        | 47,809                       | 0.1%                  |
| Additional paid-in capital                          | 495,155                       | 499,096                      | -0.8%                 |
| Legal surplus                                       | 54,407                        | 50,178                       | 8.4%                  |
| Retained earnings                                   | 94,520                        | 68,149                       | 38.7%                 |
| Treasury stock, at cost                             | (81,300)                      | (74,808)                     | -8.7%                 |
| Accumulated other comprehensive income              | 9,063                         | 37,131                       | -75.6%                |
| <b>Total stockholders' equity</b>                   | <b>\$ 771,687</b>             | <b>\$ 695,555</b>            | <b>10.9%</b>          |
| <b>Capital ratios</b>                               |                               |                              |                       |
| <b>Leverage capital</b>                             | <b>10.91%</b>                 | <b>9.65%</b>                 | <b>13.0%</b>          |
| <b>Tier 1 risk-based capital</b>                    | <b>36.33%</b>                 | <b>31.84%</b>                | <b>14.1%</b>          |
| <b>Total risk-based capital</b>                     | <b>37.63%</b>                 | <b>33.12%</b>                | <b>13.6%</b>          |
| <b>Tier 1 common equity to risk-weighted assets</b> | <b>31.03%</b>                 | <b>27.01%</b>                | <b>14.9%</b>          |
| <b>Financial assets managed</b>                     |                               |                              |                       |
| Trust assets managed                                | \$ 2,449,718                  | \$ 2,216,088                 | 10.5%                 |
| Broker-dealer assets gathered                       | 2,167,379                     | 1,926,147                    | 12.5%                 |
| <b>Total assets managed</b>                         | <b>\$ 4,617,097</b>           | <b>\$ 4,142,235</b>          | <b>11.5%</b>          |

## **OVERVIEW OF FINANCIAL PERFORMANCE**

The following discussion of the Group's financial condition and results of operations should be read in conjunction with the foregoing "Selected Financial Data" and the Group's unaudited consolidated financial statements and related notes. This discussion and analysis contains forward-looking statements. Please see "Forward-Looking Statements" and "Risk Factors" for discussion of the uncertainties, risks and assumptions associated with these statements.

The Group is a publicly-owned financial holding company that provides a full range of banking and wealth management services through its subsidiaries. It provides comprehensive banking and wealth management services through a complete range of banking and financial solutions, including mortgage, commercial and consumer lending; financing leases; checking and savings accounts; financial planning, insurance, wealth management, and investment brokerage; and corporate and individual trust and retirement services. The Group operates through three major business segments: Banking, Wealth Management, and Treasury, and distinguishes itself based on quality service and marketing efforts focused on mid and high net worth individuals and families, including professionals and owners of small and mid-sized businesses, primarily in Puerto Rico. The Group has 28 financial centers in Puerto Rico and a subsidiary in Boca Raton, Florida. The Group's long-term goal is to strengthen its banking and wealth management franchise by expanding its lending businesses, increasing the level of integration in the marketing and delivery of banking and wealth management services, maintaining effective asset-liability management, growing non-interest revenues from banking and wealth management services, and improving operating efficiencies.

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

By acquiring the BBVAPR Companies, we will accelerate our longstanding goal of creating a more stable balance sheet, with a larger and more diversified loan portfolio, a greater retail deposit funding base, and a smaller investment securities portfolio, improving earnings stability. Furthermore, in connection with the BBVAPR Acquisition, we plan to complete the sale of approximately \$1.6 billion of our and BBVAPR Bank's investment securities and use the proceeds from such sales as well as approximately \$200 million of cash to repay approximately \$1.8 billion of wholesale funding. In addition to reducing the sensitivity of our balance sheet to interest rates, the planned deleveraging would improve our capital ratios by reducing the size of our balance sheet.

We expect that the completion of the planned deleveraging will result in a one-time charge to income before income taxes of approximately \$10 million (or \$7.6 million after giving effect to income taxes), in the aggregate, which includes the expected securities mark-to-market gains or losses and the expected cost on the termination of the wholesale funding agreements. There is no expected one-time charge from the planned deleveraging of BBVAPR Bank's securities portfolio and wholesale funding since the purchase accounting fair value adjustments will reflect the sales price of the securities and the liquidation value of the liabilities being deleveraged. The \$1.8 billion planned deleveraging is also expected to result in a reduction to pre-tax income of approximately \$6.2 million in 2013 and approximately \$4.0 million in 2014 (or \$4.3 million and \$2.8 million, respectively, after giving effect to income taxes). Actual amounts will depend on market prices for the investment securities to be sold and the remaining term under the wholesale funding agreements at the time of the deleveraging transactions.

To finance in part the BBVAPR Acquisition, we have raised an aggregate amount of approximately \$158.5 million (before expenses) in common and preferred stock through the private placement of \$84 million in Convertible Preferred Stock, which closed on July 3, 2012, the underwritten public offering of approximately \$51.5 million in common stock, which closed on October 31, 2012, and the underwritten public offering of approximately \$23 million in Series D Preferred Stock, which closed on November 5, 2012.

We focused on two main initiatives during the quarter ended September 30, 2012, that is, continuing to grow our banking operations, and achieving the milestones necessary to successfully close the BBVAPR Acquisition before the end of the year. Operating revenues for the quarter ended September 30, 2012 increased 8.9%, or \$4.4 million, to \$53.9 million when compared to the same period in 2011. Operating revenues for the nine-month period ended 2012 increased 1.5%, or \$2.3 million, to \$155.5 million when compared to the same period in 2011.

The table below presents the Group's operating revenues for the quarters and nine-month periods ended September 30, 2012 and 2011:

|                                 | Quarter Ended September 30, |                  | Nine-Month Period Ended September 30, |                   |
|---------------------------------|-----------------------------|------------------|---------------------------------------|-------------------|
|                                 | 2012                        | 2011             | 2012                                  | 2011              |
|                                 | (In thousands)              |                  |                                       |                   |
| <b><u>OPERATING REVENUE</u></b> |                             |                  |                                       |                   |
| Net interest income             | \$ 40,203                   | \$ 32,470        | \$ 112,142                            | \$ 112,558        |
| Non-interest income, net        | 13,652                      | 16,965           | 43,368                                | 40,700            |
| <b>Total operating revenues</b> | <b>\$ 53,855</b>            | <b>\$ 49,435</b> | <b>\$ 155,510</b>                     | <b>\$ 153,258</b> |

### Interest Income

Total interest income for the quarter and nine-month period ended September 30, 2012 decreased 8.2% to \$65.7 million and 15.3% to \$196.4 million, respectively, as compared to the same periods in 2011. Such decrease primarily reflects a 29.6% and 41.6% decrease on interest income from investments for the quarter and nine-month period ended September 30, 2012, respectively, primarily related to lower yields and a lower balance in the investment securities portfolio as a result of the sale of \$962.8 million in mortgage-backed securities. Also, there was an increase in premium amortization due to increased prepayment speeds. The yield on investments decreased from 3.08% and 3.79% for the quarter and nine-month period ended September 30, 2011, respectively, to 2.44% and 2.50% for the quarter and nine-month period ended September 30, 2012.

The decrease in interest income on investments was mitigated by an increase in interest income from covered loans from \$18.2 million and \$45.5 million for the quarter and nine-month period ended September 30, 2011, respectively, to \$22.3 million and \$64.2 million for the quarter and nine-month period ended September 30, 2012. Also, the yield on covered loans increased from 13.73% and 10.61% for the quarter and nine-month period ended September 30, 2011, respectively, to 20.38% and 18.50% for the quarter and nine-month period ended September 30, 2012. This increase in yield is the result of higher projected cash flows on certain pools of covered loans, as credit losses have been lower than initially estimated for these loan pools. The accretable yield amounted to \$183.8 million at September 30, 2012 compared to \$188.8 million at December 31, 2011. Interest income from non-covered loans remained level.

### Interest Expense

Total interest expense for the quarter and nine-month period ended September 30, 2012 decreased 34.8% to \$25.5 million and 29.3% to \$84.3 million, respectively, as compared to the same periods in 2011. This reflects the lower cost of both, securities sold under agreements to repurchase (2.03% vs. 2.72%; 2.16% vs. 2.74%) and deposits (1.32% vs. 1.90%; 1.44% vs. 1.88%) for the quarter and nine-month period ended September 30, 2012, as compared to the same periods in 2011, which reflects continuing progress in the repricing of the Group's core retail deposits and further reductions in its cost of funds.

In December 2011, \$600 million in repurchase agreements, with an average cost of 4.23%, matured. The Group paid off \$300 million of these repurchase agreements. The remaining balance of \$300 million was renewed for an average period of approximately 3.5 years at an effective fixed rate of 2.36%. To further reduce its cost of borrowings, in May 2012, the Group renewed \$350 million in repurchase agreements, with an average cost of 4.26%, at a new effective rate of approximately 1.90%. During the quarter ended September 30, 2012, the Group initiated a plan to deleverage its balance sheet in connection with the BBVAPR Acquisition ahead of schedule by terminating repurchase agreements amounting to \$400 million with an average cost of 3.25%. In accordance with the terms of the repurchase agreements the Group had to pay cancellation fees amounting to \$24.3 million. As a result of the aforementioned transactions, total interest expense on securities sold under agreements to repurchase declined 33.9% and 30.3% during the quarter and nine-month period ended September 30, 2012, respectively, as compared to the same periods in 2011.



### **Net Interest Income**

Net interest income for the quarter and nine-month period ended September 30, 2012 was \$40.2 million and \$112.1 million, respectively, an increase of 23.8% and a slight decrease of 0.4% when compared with the same periods in 2011. The increase for the quarter ended September 30, 2012 was mostly due to the net effect of a 22.3% increase in interest income from covered loans as a result of higher yields and a 34.8% decrease in interest expense due to lower cost of funds, offset by a decrease of 29.6% on interest income from investments, related to lower yields and a lower balance in the investment securities portfolio.

Net interest margin of 2.77% and 2.55% for the quarter and nine-month period ended September 30, 2012 increased 74 and 24 basis points, respectively, when compared to the same periods in 2011.

### **Provision for Loan and Lease Losses**

Provision for non-covered loans and lease losses for the quarter and nine-month period ended September 30, 2012 decreased \$200 thousand and \$1 million, respectively, when compared to the same periods in the previous year. Provision for covered loans and lease losses for the quarter and nine-month period ended September 30, 2012 was \$221 thousand and \$8.8 million, respectively, reflecting the Group's revision to the expected cash flows in the covered loan portfolio considering actual experiences and changes in the Group's expectations for the remaining terms of the loan pools. During the first quarter of 2012, some covered construction and development and commercial real estate loan pools underperformed, which required a provision amounting to \$7.2 million, net of the estimated reimbursement from the FDIC. Additional net provisions of \$1.5 million and \$221 thousand were recorded for the quarters ended June 30, 2012 and September 30, 2012, respectively.

### **Non-Interest Income**

During the quarter and nine-month period ended September 30, 2012, core banking and wealth management revenues increased 1.2% to \$11.3 million and 9.8% to \$34.2 million, respectively, as compared to the same periods in 2011, primarily reflecting a \$655 thousand and \$3.2 million increase in wealth management revenues to \$6.0 million and \$17.8 million, respectively, attributed to an increase of 11.5% in assets under management from December 31, 2011.

Net amortization of the FDIC shared-loss indemnification asset of \$8.1 million and \$18.5 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to a net amortization of \$2.4 million and \$191 thousand for the same periods in 2011, resulted from the ongoing evaluation of expected cash flows of the loan

portfolio acquired in the FDIC-assisted acquisition. As a result of such evaluation, the Group expects a decrease in losses to be collected from the FDIC and the improved re-yielding of the accretable yield on the covered loans. This reduction in claimable losses amortizes the shared-loss indemnification asset through the life of the shared-loss agreements. This amortization is net of the accretion of the discount recorded to reflect the expected claimable loss at its net present value.

The quarter and nine-month period ended September 30, 2012 include a gain on the sale of investment securities of \$36.4 million and \$55.7 million, respectively, as the Group took advantage of market opportunities and initiated its deleverage in connection with the BBVAPR Acquisition. The purpose of the deleverage plan is to reduce the Group's capital needs for the BBVAPR Acquisition; to enhance its returns going forward; and to have a more traditional bank balance sheet following the BBVAPR Acquisition. As part of this plan, in the quarter ended September 30, 2012, the Group sold \$532.4 million of securities with an average book yield of 3.86%. At the same time, the Group terminated prior to maturity \$400 million of repurchase agreements with an average cost of 3.33%.

### **Non-Interest Expense**

Non-interest expense slightly increased to \$30.4 million for the quarter ended September 30, 2012, and decreased to \$88.0 million for the nine-month period then ended, compared to \$30.2 million and \$91.2 million in the same periods of the previous year. The quarter ended September 30, 2012 included approximately \$1.5 million in expenses related to the proposed BBVAPR Acquisition.

The efficiency ratio for the quarter and nine-month period ended September 30, 2012 was 59.04% and 60.13%, respectively, compared to 69.30% and 63.49% for the quarter and nine-month period ended September 30, 2011.

## **Income Tax Expense**

Income tax expense was \$1.9 million and \$4.9 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to an expense of \$580 thousand and \$5.7 million for the same periods in 2011.

At December 31, 2011, OIB had \$2.9 million in income tax effect of unrecognized gain on available-for-sale securities included in other comprehensive income. Following the change in OIB's applicable tax rate from 5% to 0% as a result of new Puerto Rico legislation adopted in 2011, this remaining tax balance will flow through income as these securities are repaid or sold in future periods. During the quarter and nine-month period ended September 30, 2012, income tax provision included \$1.1 million and \$1.8 million, respectively, related to this residual tax effect from OIB.

## **Income Available to Common Shareholders**

For the quarter and nine-month period ended September 30, 2012, the Group's income available to common shareholders amounted to \$14.7 million and \$37.9 million, respectively, compared to \$15.6 million and \$42.7 million for the same periods in 2011. Earnings per basic common share and fully diluted common share were \$0.36 and \$0.35 for the quarter ended September 30, 2012, respectively, compared to income per basic and fully diluted common share of \$0.35 for the quarter ended September 30, 2011. Income per basic common share and fully diluted common share were \$0.93 and \$0.92, respectively, for the nine-month period ended September 30, 2012, compared to income per basic and fully diluted common share of \$0.95 for the nine-month period ended September 30, 2011. The quarter ended September 30, 2012 included \$1.8 million in dividends declared on the Convertible Preferred Stock issued early in the quarter in connection with the BBVAPR Acquisition.

## **Interest Earning Assets**

The investment portfolio amounted to \$3.153 billion at September 30, 2012, a 18.5% decrease compared to \$3.868 billion at December 31, 2011. The decrease in the investment portfolio reflects a reduction of 22.51%, or \$666.4 million, in the available-for-sale portfolio, due to the sale of approximately \$1.090 billion in investment securities as part of the Group's ongoing strategy of replacing securities with loans and selling mortgage-backed securities subject to high prepayment speeds, and a decrease of 5.5%, or \$48.9 million, in the held-to-maturity portfolio. The decrease is also attributed to the sale of \$532.4 million of securities during the quarter ended September 30, 2012 as part of our balance sheet deleveraging in connection with the BBVAPR Acquisition. The loan portfolio decreased 4.2% to \$1.596 billion at September 30, 2012, compared to \$1.666 billion at December 31, 2011. The decrease in the loan portfolio is mostly due to an increase of \$19.6 million, in the allowance for loan and lease losses on covered loans and a decrease of 11.8% in covered loans as they continue to be repaid.

## Interest Bearing Liabilities

Total deposits amounted to \$2.214 billion at September 30, 2012, a decrease of 9.1% compared to \$2.435 billion at December 31, 2011. Core retail deposits, which exclude institutional and brokered deposits, declined \$11.6 million, or 0.6%, compared to December 31, 2011, while wholesale deposits decreased \$209.2 million or 49.3% as higher cost deposits matured during the period. Non-interest bearing demand deposits, interest-bearing savings and demand deposits and individual retirement accounts increased 2.8%, 1.9% and 2.3%, respectively, while retail certificates of deposits decreased 12.1%.

Using available cash, in March 2012, the Bank repaid at maturity \$105.0 million in senior unsecured notes issued in March 2009 under the FDIC's Temporary Liquidity Guarantee Program ("TLGP") with an all-in cost of 3.75%.

During the nine-month period ended September 30, 2012, the Group renewed \$350 million in repurchase agreements with an average cost of 4.26%, at a new effective rate of approximately 1.90%, as one-month short-term repurchase agreements. The repurchase agreements are being rolled over on a monthly basis on the same terms as the variable rate leg of the interest rate swaps that are designated as cash flow hedges of such repurchase agreements. In addition during the quarter ended September 30, 2012, the Group elected to terminate repurchase agreements amounting to \$400 million with an average cost of 3.25%, as part of the previously mentioned deleverage plan in connection with the BBVAPR Acquisition. Due to the repayment of the TLGP notes and the termination of the repurchase agreements, total borrowings decreased 14.5% to \$2.974 billion at September 30, 2012, compared to \$3.480 billion at December 31, 2011.

## **Stockholders' Equity**

Stockholders' equity at September 30, 2012 was \$771.7 million, compared to \$695.6 million at December 31, 2011, an increase of 10.9%. This increase is mainly due to the \$84 million issuance of the Convertible Preferred Stock on July 3, 2012, partially offset by a decrease in other comprehensive income for such period.

Book value per share was \$15.40 at September 30, 2012 compared to \$15.28 at December 31, 2011.

The Group maintains capital ratios in excess of regulatory requirements. At September 30, 2012, Tier 1 Leverage Capital Ratio was 10.91% (2.73 times the requirement of 4.00%), Tier 1 Risk-Based Capital Ratio was 36.33% (9.08 times the requirement of 4.00%), and Total Risk-Based Capital Ratio was 37.63% (4.70 times the requirement of 8.00%).

## **Return on Average Assets and Common Equity**

Return on average common equity ("ROE") for the quarter and nine-month period ended September 30, 2012 was 9.27% and 8.01%, respectively, down from 9.41% and 8.65% for the quarter and nine-month period ended September 30, 2011. Return on average assets ("ROA") for the quarter and nine-month period ended September 30, 2012 was 1.11% and 0.89%, respectively, up from 0.95% and 0.86% for the same periods in 2011. The increase in ROA is mainly due to the 9.6% decrease in total assets as of September 30, 2012, when compared to the balance at December 31, 2011.

## **Assets under Management**

Assets managed by the Group's trust division, the pension plan administration subsidiary (CPC), and Oriental Financial Services increased from \$4.142 billion as of December 31, 2011 to \$4.617 billion as of September 30, 2012. The trust division offers various types of individual retirement accounts ("IRA") and manages 401(k) and Keogh retirement plans and custodian and corporate trust accounts, while CPC manages the administration of private retirement plans. At September 30, 2012, total assets managed by the Group's trust division and CPC increased to \$2.450 billion, compared to \$2.216 billion at December 31, 2011, mainly related to account contributions and capital market appreciation. At September 30, 2012, total assets managed by Oriental Financial Services from its customer investment accounts increased to \$2.167 billion, compared to \$1.926 billion at December 31, 2011, also mainly

because of account contributions and capital market appreciation.

## **Lending**

Total loan production of \$313.3 million for the nine-month period ended September 30, 2012 increased 8.5% year over year, including \$106.4 million in the quarter ended September 30, 2012. Total commercial loan production of \$134.8 million for the nine-month period ended September 30, 2012, increased 46.0% from the year ago period, including \$43.6 million in the quarter ended September 30, 2012.

The Group sells most of its conforming mortgages in the secondary market, and retains servicing rights. As a result, mortgage banking activities reflect originations as well as a growing servicing portfolio, a source of recurring revenue.

Mortgage loan production and purchases of \$47.0 million and \$140.9 million for the quarter and nine-month period ended September 30, 2012, respectively, decreased 10.8% and 14.7% from the same periods in 2011. Leasing and consumer loans production for the quarter and nine-month period ended September 30, 2012 totaled \$15.8 million and \$37.6 million, up 39.9% and 20.6% from the same periods in 2011.

## **Credit Quality on Non-Covered Loans**

Net credit losses increased \$1.3 million to \$8.3 million during the nine-month period ended September 30, 2012, representing 0.92% of average non-covered loans outstanding, versus 0.79% in 2011. The allowance for loan and lease losses on non-covered loans increased to \$39.1 million (3.29% of total non-covered loans) at September 30, 2012, compared to \$37.0 million (3.12% of total non-covered loans) at December 31, 2011.

Non-performing loans (“NPLs”), which excludes loans covered under shared-loss agreements with the FDIC, decreased 12.56%, or \$16.9 million, in the nine-month period ended September 30, 2012. The Group does not expect NPLs to result in significantly higher losses as most are well-collateralized with adequate loan-to-value ratios. In residential mortgage lending, more than 90% of the Group’s portfolio consists of fixed-rate, fully amortizing, fully documented loans that do not have the level of risk generally associated with subprime loans. In commercial lending, more than 90% of our loans are collateralized by real estate. Early delinquency loans (30-89 days past due) dropped 10.6% from December 31, 2011. Covered loans are considered to be performing due to the application of the accretion method under ASC 310-30.

### Non-GAAP Measures

The Group uses certain non-GAAP measures of financial performance to supplement the financial statements presented in accordance with GAAP. The Group presents non-GAAP measures that management believes are useful and meaningful to investors. Non-GAAP measures do not have any standardized meaning and are therefore unlikely to be comparable to similar measures presented by other companies. The presentation of non-GAAP measures is not intended to be a substitute for, and should not be considered in isolation from, the financial measures reported in accordance with GAAP.

The Group’s management has reported and discussed the results of operations herein both on a GAAP basis and on a pre-tax pre-provision operating income basis (defined as net interest income, plus banking and wealth management revenues, less non-interest expenses, as calculated on the table below). The Group’s management believes that, given the nature of the items excluded from the definition of pre-tax pre-provision operating income, it is useful to state what the results of operations would have been without them so that investors can see the financial trends from the Group’s continuing business.

During the quarter and nine-month period ended September 30, 2012, the Group’s pre-tax pre-provision operating income was approximately \$21.1 million and \$58.3 million, respectively, an increase of 57.5% and 11.2% from \$13.4 million and \$52.5 million in the same periods of last year. Pre-tax pre-provision operating income is calculated as follows:

|  | Quarter Ended September 30, |      | Nine-Month Period Ended<br>September 30, |      |
|--|-----------------------------|------|--|------|
|  | 2012                        | 2011 | 2012                                     | 2011 |
|  | (In thousands)              |      |  |      |
| <b><u>PRE-TAX PRE-PROVISION<br/>OPERATING INCOME</u></b> |                             |      |  |      |

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|                                       |    |               |    |               |    |               |    |               |
|---------------------------------------|----|---------------|----|---------------|----|---------------|----|---------------|
| Net interest income                   | \$ | 40,203        | \$ | 32,470        | \$ | 112,142       | \$ | 112,558       |
| Core non-interest income:             |    |               |    |               |    |               |    |               |
| Wealth management revenues            |    | 6,042         |    | 5,387         |    | 17,835        |    | 14,644        |
| Banking service revenues              |    | 3,006         |    | 2,969         |    | 9,231         |    | 9,496         |
| Mortgage banking activities           |    | 2,204         |    | 2,758         |    | 7,142         |    | 7,017         |
| <b>Total core non-interest income</b> |    | <b>11,252</b> |    | <b>11,114</b> |    | <b>34,208</b> |    | <b>31,157</b> |
| Less non interest expenses            |    | (30,379)      |    | (30,203)      |    | (88,006)      |    | (91,248)      |
| <b>Total pre-tax pre-provision</b>    |    | <b>21,076</b> |    | <b>13,381</b> |    | <b>58,344</b> |    | <b>52,467</b> |
| <b>operating income</b>               |    |               |    |               |    |               |    |               |

Tangible common equity consists of common equity less goodwill and core deposit intangibles. Tier 1 common equity consists of common equity less goodwill, core deposit intangibles, net unrealized gains on available for sale securities, net unrealized losses on cash flow hedges, and disallowed deferred tax asset and servicing assets. Management believes that the ratios of tangible common equity to total assets, tangible common equity to risk-weighted assets, total equity to risk-weighted assets and tier 1 common equity to risk-weighted assets, assist investors in analyzing the Group's capital position.

At September 30, 2012, tangible common equity to total assets and tangible common equity to risk-weighted assets increased to 10.30% and 32.96%, respectively, from 9.36% and 30.14% at December 31, 2011. Total equity to risk-weighted assets and Tier 1 common equity to risk-weighted assets at September 30, 2012 increased to 40.79% and 31.03%, respectively, from 33.48% and 27.01% at December 31, 2011.



**ANALYSIS OF  
RESULTS OF  
OPERATIONS**

**TABLE 1 - QUARTERLY ANALYSIS OF NET INTEREST INCOME AND CHANGES DUE TO VOLUME/RATE FOR THE QUARTERS ENDED SEPTEMBER 30, 2012 AND 2011**

|   | Interest<br>September<br>2012 | September<br>2011 | Average rate<br>September<br>2012 | September<br>2011 | Average balance<br>September<br>2012 | September<br>2011 |
|---|-------------------------------|-------------------|-----------------------------------|-------------------|--------------------------------------|-------------------|
|   | (Dollars in thousands)        |                   |                                   |                   |                                      |                   |
| <b>A - TAX<br/>EQUIVALENT<br/>SPREAD</b>                      |                               |                   |                                   |                   |                                      |                   |
| <b>Interest-earning<br/>assets</b>                            | \$ 65,686                     | \$ 71,536         | 4.52%                             | 4.46%             | \$ 5,806,796                         | \$ 6,409,910      |
| Tax equivalent<br>adjustment                                  | 17,994                        | 13,505            | 1.24%                             | 0.84%             | -                                    | -                 |
| <b>Interest-earning<br/>assets - tax<br/>equivalent</b>       | <b>83,680</b>                 | <b>85,041</b>     | <b>5.76%</b>                      | <b>5.30%</b>      | <b>5,806,796</b>                     | <b>6,409,910</b>  |
| Interest-bearing<br>liabilities                               | 25,483                        | 39,066            | 1.83%                             | 2.49%             | 5,562,082                            | 6,263,930         |
| <b>Tax equivalent net<br/>interest income /<br/>spread</b>    | <b>58,197</b>                 | <b>45,975</b>     | <b>3.93%</b>                      | <b>2.81%</b>      | <b>244,714</b>                       | <b>145,980</b>    |
| <b>Tax equivalent<br/>interest rate margin</b>                |                               |                   | <b>4.01%</b>                      | <b>2.87%</b>      |                                      |                   |
| <b>B - NORMAL<br/>SPREAD</b>                                  |                               |                   |                                   |                   |                                      |                   |
| <b>Interest-earning<br/>assets:</b>                           |                               |                   |                                   |                   |                                      |                   |
| <b>Investments:</b>   |                               |                   |                                   |                   |                                      |                   |
| Investment<br>securities                                      | 25,026                        | 35,881            | 3.00%                             | 3.35%             | 3,341,763                            | 4,288,321         |
| Money market<br>investments                                   | 413                           | 272               | 0.20%                             | 0.27%             | 827,106                              | 410,258           |
| <b>Total<br/>investments</b>                                  | <b>25,439</b>                 | <b>36,153</b>     | <b>2.44%</b>                      | <b>3.08%</b>      | <b>4,168,869</b>                     | <b>4,698,579</b>  |
| <b>Loans not covered<br/>under shared-loss<br/>agreements</b> |                               |                   |                                   |                   |                                      |                   |
| <b>with the FDIC:</b>   |                               |                   |                                   |                   |                                      |                   |
| Mortgage  | 12,165                        | 12,105            | 6.01%                             | 5.59%             | 808,949                              | 866,947           |

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|   |               |                     |               |                  |                  |
|---|---------------|---------------------|---------------|------------------|------------------|
| Commercial  | 4,313         | 3,612 5.43%         | 5.54%         | 317,888          | 260,932          |
| Consumer  | 869           | 977 8.20%           | 11.43%        | 42,382           | 34,188           |
| Leasing   | 617           | 467 7.85%           | 10.05%        | 31,426           | 18,584           |
| <b>Total non-covered loans</b>                    | <b>17,964</b> | <b>17,161 5.98%</b> | <b>5.81%</b>  | <b>1,200,645</b> | <b>1,180,651</b> |
| <b>Loans covered under shared-loss agreements</b> |               |                     |               |                  |                  |
| <b>with the FDIC:</b>                             |               |                     |               |                  |                  |
| Loans secured by residential properties           | 5,162         | 4,096 3.71%         | 10.20%        | 150,599          | 159,891          |
| Commercial and construction                       | 13,664        | 11,727 1.03%        | 13.20%        | 259,922          | 305,859          |
| Leasing   | 2,546         | 2,047 4.15%         | 15.85%        | 15,876           | 51,669           |
| Consumer  | 911           | 352 3.48%           | 8.95%         | 10,886           | 13,261           |
| <b>Total covered loans</b>                        | <b>22,283</b> | <b>18,220 3.38%</b> | <b>13.73%</b> | <b>437,282</b>   | <b>530,680</b>   |
| <b>Total loans</b>                                | <b>40,247</b> | <b>35,383 9.83%</b> | <b>8.27%</b>  | <b>1,637,927</b> | <b>1,711,331</b> |
| <b>Total interest earning assets</b>              | <b>65,686</b> | <b>71,536 4.52%</b> | <b>4.46%</b>  | <b>5,806,796</b> | <b>6,409,910</b> |
| <b>Interest-bearing liabilities:</b>              |               |                     |               |                  |                  |
| <b>Deposits:</b>                                  |               |                     |               |                  |                  |
| Non-interest bearing deposits                     | -             | - 0.00%             | 0.00%         | 179,480          | 177,936          |
| NOW accounts                                      | 1,964         | 3,203 0.90%         | 1.56%         | 877,129          | 822,420          |
| Savings and money market                          | 583           | 855 0.98%           | 1.40%         | 236,989          | 244,341          |
| Individual retirement accounts                    | 2,104         | 2,443 2.28%         | 2.74%         | 368,365          | 356,770          |
| Retail certificates of deposits                   | 1,598         | 2,372 1.92%         | 2.36%         | 332,727          | 402,158          |
| <b>Total retail deposits</b>                      | <b>6,249</b>  | <b>8,873 1.25%</b>  | <b>1.77%</b>  | <b>1,994,690</b> | <b>2,003,625</b> |
| Institutional deposits                            | 228           | 1,024 1.20%         | 2.12%         | 76,282           | 193,448          |
| Brokered deposits                                 | 831           | 1,595 2.34%         | 2.81%         | 141,859          | 226,681          |
| <b>Total wholesale deposits</b>                   | <b>1,059</b>  | <b>2,619 1.94%</b>  | <b>2.49%</b>  | <b>218,141</b>   | <b>420,129</b>   |
| <b>Total deposits</b>                             | <b>7,308</b>  | <b>11,492 1.32%</b> | <b>1.90%</b>  | <b>2,212,831</b> | <b>2,423,754</b> |
| <b>Borrowings:</b>                                |               |                     |               |                  |                  |
| Securities sold under agreements to repurchase    | 15,344        | 23,206 2.03%        | 2.72%         | 3,027,100        | 3,411,161        |
| Advances from FHLB and other borrowings           | 2,508         | 3,042 3.51%         | 4.24%         | 286,068          | 286,909          |
| FDIC-guaranteed term notes                        | -             | 1,021 -             | 3.85%         | -                | 106,023          |

|  |               |                  |              |              |                   |                   |
|--|---------------|------------------|--------------|--------------|-------------------|-------------------|
| Subordinated capital notes   | 323           | 305              | 3.58%        | 3.38%        | 36,083            | 36,083            |
| <b>Total borrowings</b>  | <b>18,175</b> | <b>27,574</b>    | <b>2.17%</b> | <b>2.87%</b> | <b>3,349,251</b>  | <b>3,840,176</b>  |
| <b>Total interest bearing liabilities</b>  | <b>25,483</b> | <b>39,066</b>    | <b>1.83%</b> | <b>2.49%</b> | <b>5,562,082</b>  | <b>6,263,930</b>  |
| <b>Net interest income / spread</b>  | <b>40,203</b> | <b>\$ 32,470</b> | <b>2.69%</b> | <b>1.97%</b> |                   |                   |
| <b>Interest rate margin</b>  |               |                  | <b>2.77%</b> | <b>2.03%</b> |                   |                   |
| <b>Excess of average interest-earning assets</b>                                     |               |                  |              |              | <b>\$ 244,714</b> | <b>\$ 145,980</b> |
| <b>over average interest-bearing liabilities</b>                                     |               |                  |              |              |                   |                   |
| <b>Average interest-earning assets to average interest-bearing liabilities ratio</b> |               |                  |              |              | <b>104.40%</b>    | <b>102.33%</b>    |

**C - CHANGES IN NET INTEREST INCOME DUE TO:**

|  | <b>Volume</b> | <b>Rate</b>           |           | <b>Total</b>   |           |                 |
|--|---------------|-----------------------|-----------|----------------|-----------|-----------------|
|  |               | <b>(In thousands)</b> |           |                |           |                 |
| <b>Interest Income:</b>                        |               |                       |           |                |           |                 |
| Investments                                    | \$            | (4,076)               | \$        | (6,638)        | \$        | (10,714)        |
| Loans  |               | (2,916)               |           | 7,780          |           | 4,864           |
| <b>Total interest income</b>                   |               | <b>(6,992)</b>        |           | <b>1,142</b>   |           | <b>(5,850)</b>  |
| <b>Interest Expense:</b>                       |               |                       |           |                |           |                 |
| Deposits                                       |               | (1,000)               |           | (3,184)        |           | (4,184)         |
| Securities sold under agreements to repurchase |               | (2,613)               |           | (5,249)        |           | (7,862)         |
| Other borrowings                               |               | (1,088)               |           | (449)          |           | (1,537)         |
| <b>Total interest expense</b>                  |               | <b>(4,701)</b>        |           | <b>(8,882)</b> |           | <b>(13,583)</b> |
| <b>Net Interest Income</b>                     | <b>\$</b>     | <b>(2,291)</b>        | <b>\$</b> | <b>10,024</b>  | <b>\$</b> | <b>7,733</b>    |

**TABLE 1/A - YEAR-TO-DATE ANALYSIS OF NET INTEREST INCOME AND CHANGES DUE TO VOLUME/RATE FOR THE NINE-MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011**

|   | Interest<br>September<br>2012 | September<br>2011 | Average rate<br>September<br>2012 | Average rate<br>September<br>2011 | Average balance<br>September<br>2012 | Average balance<br>September<br>2011 |
|---|-------------------------------|-------------------|-----------------------------------|-----------------------------------|--------------------------------------|--------------------------------------|
|   | (Dollars in thousands)        |                   |                                   |                                   |                                      |                                      |
| <b>A - TAX EQUIVALENT SPREAD</b>                      |                               |                   |                                   |                                   |                                      |                                      |
| <b>Interest-earning assets</b>                        | \$ 196,393                    | \$ 231,772        | 4.46%                             | 4.76%                             | \$ 5,870,015                         | \$ 6,495,208                         |
| Tax equivalent adjustment                             | 46,890                        | 44,461            | 1.07%                             | 0.91%                             | -                                    | -                                    |
| <b>Interest-earning assets - tax equivalent</b>       | <b>243,283</b>                | <b>276,233</b>    | <b>5.53%</b>                      | <b>5.67%</b>                      | <b>5,870,015</b>                     | <b>6,495,208</b>                     |
| Interest-bearing liabilities                          | 84,251                        | 119,214           | 1.98%                             | 2.49%                             | 5,670,500                            | 6,371,511                            |
| <b>Tax equivalent net interest income / spread</b>    | <b>159,032</b>                | <b>157,019</b>    | <b>3.55%</b>                      | <b>3.18%</b>                      | <b>199,515</b>                       | <b>123,697</b>                       |
| <b>Tax equivalent interest rate margin</b>            |                               |                   | <b>3.61%</b>                      | <b>3.22%</b>                      |                                      |                                      |
| <b>B - NORMAL SPREAD</b>                              |                               |                   |                                   |                                   |                                      |                                      |
| <b>Interest-earning assets:</b>                       |                               |                   |                                   |                                   |                                      |                                      |
| <b>Investments:</b>                                   |                               |                   |                                   |                                   |                                      |                                      |
| Investment securities                                 | 77,718                        | 134,378           | 2.94%                             | 4.09%                             | 3,521,595                            | 4,379,701                            |
| Money market investments                              | 1,200                         | 792               | 0.23%                             | 0.28%                             | 685,380                              | 372,247                              |
| <b>Total investments</b>                              | <b>78,918</b>                 | <b>135,170</b>    | <b>2.50%</b>                      | <b>3.79%</b>                      | <b>4,206,975</b>                     | <b>4,751,948</b>                     |
| <b>Loans not covered under shared-loss agreements</b> |                               |                   |                                   |                                   |                                      |                                      |
| <b>with the FDIC:</b>                                 |                               |                   |                                   |                                   |                                      |                                      |
| Mortgage  | 36,645                        | 36,604            | 5.94%                             | 5.55%                             | 822,116                              | 879,463                              |
| Commercial  | 12,463                        | 10,616            | 5.37%                             | 5.78%                             | 309,373                              | 245,053                              |
| Consumer  | 2,465                         | 2,847             | 8.22%                             | 11.86%                            | 39,993                               | 32,019                               |
| Leasing   | 1,735                         | 1,028             | 7.94%                             | 9.20%                             | 29,126                               | 14,906                               |
|   | <b>53,308</b>                 | <b>51,095</b>     | <b>5.92%</b>                      | <b>5.82%</b>                      | <b>1,200,608</b>                     | <b>1,171,441</b>                     |

|   |                |                |              |               |                  |                  |
|---|----------------|----------------|--------------|---------------|------------------|------------------|
| <b>Total non-covered loans</b>                    |                |                |              |               |                  |                  |
| <b>Loans covered under shared-loss agreements</b> |                |                |              |               |                  |                  |
| <b>with the FDIC:</b>                             |                |                |              |               |                  |                  |
| Loans secured by residential properties           | 15,494         | 10,977         | 13.52%       | 8.46%         | 152,852          | 172,977          |
| Commercial and construction                       | 40,383         | 27,001         | 9.70%        | 11.23%        | 273,284          | 320,514          |
| Leasing   | 6,801          | 6,325          | 7.47%        | 13.25%        | 24,200           | 63,659           |
| Consumer  | 1,489          | 1,204          | 6.41%        | 10.94%        | 12,096           | 14,669           |
| <b>Total covered loans</b>                        | <b>64,167</b>  | <b>45,507</b>  | <b>8.50%</b> | <b>10.61%</b> | <b>462,432</b>   | <b>571,819</b>   |
| <b>Total loans</b>                                | <b>117,475</b> | <b>96,602</b>  | <b>9.42%</b> | <b>7.39%</b>  | <b>1,663,040</b> | <b>1,743,260</b> |
| <b>Total interest earning assets</b>              | <b>196,393</b> | <b>231,772</b> | <b>4.46%</b> | <b>4.76%</b>  | <b>5,870,015</b> | <b>6,495,208</b> |
| <b>Interest-bearing liabilities:</b>              |                |                |              |               |                  |                  |
| <b>Deposits:</b>                                  |                |                |              |               |                  |                  |
| Non-interest bearing deposits                     | -              | -              | -            | -             | 176,158          | 179,071          |
| NOW accounts                                      | 6,781          | 9,969          | 1.04%        | 1.63%         | 872,059          | 813,179          |
| Savings and money market                          | 1,790          | 2,715          | 1.01%        | 1.49%         | 235,675          | 243,529          |
| Individual retirement accounts                    | 6,557          | 7,527          | 2.38%        | 2.80%         | 367,461          | 358,516          |
| Retail certificates of deposits                   | 5,366          | 7,975          | 2.10%        | 2.39%         | 341,339          | 445,087          |
| <b>Total retail deposits</b>                      | <b>20,494</b>  | <b>28,186</b>  | <b>1.37%</b> | <b>1.84%</b>  | <b>1,992,692</b> | <b>2,039,382</b> |
| Institutional deposits                            | 1,098          | 2,846          | 1.54%        | 1.70%         | 95,192           | 222,940          |
| Brokered deposits                                 | 2,926          | 4,289          | 2.11%        | 2.39%         | 184,652          | 239,169          |
| <b>Total wholesale deposits</b>                   | <b>4,024</b>   | <b>7,135</b>   | <b>1.92%</b> | <b>2.06%</b>  | <b>279,844</b>   | <b>462,109</b>   |
| <b>Total deposits</b>                             | <b>24,518</b>  | <b>35,321</b>  | <b>1.44%</b> | <b>1.88%</b>  | <b>2,272,536</b> | <b>2,501,491</b> |
| <b>Borrowings:</b>                                |                |                |              |               |                  |                  |
| Securities sold under agreements to repurchase    | 49,414         | 70,878         | 2.16%        | 2.74%         | 3,047,605        | 3,445,167        |
| Advances from FHLB and other borrowings           | 8,438          | 9,036          | 3.95%        | 4.26%         | 284,822          | 283,028          |
| FDIC-guaranteed term notes                        | 909            | 3,063          | 4.11%        | 3.86%         | 29,454           | 105,742          |
| Subordinated capital notes                        | 972            | 916            | 3.59%        | 3.38%         | 36,083           | 36,083           |

|  |                |                        |              |                   |                   |
|--|----------------|------------------------|--------------|-------------------|-------------------|
| <b>Total borrowings</b>  | <b>59,733</b>  | <b>83,8932.34%</b>     | <b>2.89%</b> | <b>3,397,964</b>  | <b>3,870,020</b>  |
| <b>Total interest bearing liabilities</b>  | <b>84,251</b>  | <b>119,2141.98%</b>    | <b>2.49%</b> | <b>5,670,499</b>  | <b>6,371,511</b>  |
| <b>Net interest income / spread</b> \$   | <b>112,142</b> | <b>\$ 112,5582.48%</b> | <b>2.27%</b> |                   |                   |
| <b>Interest rate margin</b>  |                | <b>2.55%</b>           | <b>2.31%</b> |                   |                   |
| <b>Excess of average interest-earning assets</b>                                     |                |                        |              | <b>\$ 199,514</b> | <b>\$ 123,697</b> |
| <b>over average interest-bearing liabilities</b>                                     |                |                        |              |                   |                   |
| <b>Average interest-earning assets to average interest-bearing liabilities ratio</b> |                |                        |              | <b>103.52%</b>    | <b>101.94%</b>    |

**C - CHANGES IN NET INTEREST INCOME DUE TO:**

|  | <b>Volume</b> | <b>Rate</b>           |                 | <b>Total</b>    |
|--|---------------|-----------------------|-----------------|-----------------|
|  |               | <b>(In thousands)</b> |                 |                 |
| <b>Interest Income:</b>                        |               |                       |                 |                 |
| Investments                                    | \$            | (15,502)              | \$ (40,750)     | \$ (56,252)     |
| Loans  |               | (7,433)               | 28,306          | 20,873          |
| <b>Total interest income</b>                   |               | <b>(22,935)</b>       | <b>(12,444)</b> | <b>(35,379)</b> |
| <b>Interest Expense:</b>                       |               |                       |                 |                 |
| Deposits                                       |               | (3,233)               | (7,570)         | (10,803)        |
| Securities sold under agreements to repurchase |               | (8,179)               | (13,285)        | (21,464)        |
| Other borrowings                               |               | (2,282)               | (414)           | (2,696)         |
| <b>Total interest expense</b>                  |               | <b>(13,694)</b>       | <b>(21,269)</b> | <b>(34,963)</b> |
| <b>Net Interest Income</b>                     | <b>\$</b>     | <b>(9,241)</b>        | <b>\$ 8,825</b> | <b>\$ (416)</b> |



## Net Interest Income

Net interest income is a function of the difference between rates earned on the Group's interest-earning assets and rates paid on its interest-bearing liabilities (interest rate spread) and the relative amounts of its interest earning assets and interest-bearing liabilities (interest rate margin). The Group constantly monitors the composition and re-pricing of its assets and liabilities to maintain its net interest income at adequate levels. Tables 1 and 1A above show the major categories of interest-earning assets and interest-bearing liabilities, their respective interest income, expenses, yields and costs, and their impact on net interest income due to changes in volume and rates for the quarters and nine-month periods ended September 30, 2012 and 2011, respectively.

Net interest income amounted to \$40.2 million and \$112.1 million for the quarter and nine-month period ended September 30, 2012, an increase of 23.8% and a slight decrease of 0.4% from \$32.5 million and \$112.6 million, respectively, for the same periods in 2011. These changes reflect a decrease of 29.6% in interest income from investments, partially offset by a 13.7% increase in interest income from loans and a decrease of 34.8% in interest expense for the quarter ended September 30, 2012 compared to the same period in 2011. They also reflect a decrease of 41.6% in interest income from investments, partially offset by a 21.6% increase in interest income from loans and a decrease of 29.3% in interest expense for the nine-month period ended September 30, 2012 compared to the same period in 2011.

Interest rate spread increased 72 basis points to 2.69% for the quarter ended 2012 from 1.97% in the quarter ended September 30, 2011. This is due to the effect of a 6 basis points increase in the average yield of interest earning assets from 4.46% to 4.52%, combined with a 66 basis points decrease in the average cost of funds from 2.49% to 1.83%. For the nine-month period ended September 30, 2012, interest rate spread increased 21 basis points from 2.27% to 2.48% in the same period of 2011. This increase is mainly due to the net effect of a 51 basis points decrease in the average cost of funds from 2.49% to 1.98%, and a 30 basis points decrease in the average yield of interest earning assets from 4.76% to 4.46%.

The decrease in interest income for the quarter was primarily the net effect of a decrease of \$7.0 million in interest-earning assets volume variance, and a \$1.1 million increase in interest rate variance. The nine-month period decrease in interest income was primarily the result of a decrease of \$22.9 million in interest-earning assets volume variance, and a \$12.4 million decrease in interest rate variance. Interest income from loans increased 13.7% to \$40.2 million and 21.6% to \$117.5 million for the quarter and nine-month period ended September 30, 2012, respectively. During the quarter and nine-month period ended September 30, 2012, interest income from covered loans increased 22.3% to \$22.3 million and 41.0% to \$64.2 million, respectively, compared to the same periods in 2011, mainly due to the re-yielding of various pools of covered loans mainly during the second half of 2011. Interest income on investments decreased 29.6% to \$25.4 million and 41.6% to \$78.9 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to the same periods in 2011, reflecting lower balance in the investment securities portfolio, lower yield on investment securities and an increase in premium amortization due to

increased prepayment speeds.

Interest expense decreased 34.8% to \$25.5 million and 29.3% to \$84.3 million for the quarter and nine-month period ended September 30, 2012, respectively. The decrease for the quarter was primarily the result of a \$8.9 million decrease in interest rate variance, and a \$4.7 million decrease in interest-bearing liabilities volume variance. The nine-month period decrease was primarily the result of a \$21.3 million decrease in interest rate variance, and a \$13.7 million decrease in interest-bearing liabilities volume variance. These decreases are due to a reduction in the balance of interest bearing liabilities and the cost of funds. Interest bearing liabilities interest rate spread decreased 66 basis points to 1.83% and 51 basis points to 1.98% for the quarter and nine-month period ended September 30, 2012, respectively, compared to the same periods in 2011. The cost of deposits decreased by 58 basis points to 1.32% and 44 basis points to 1.44% during the quarter and nine-month period ended September 30, 2012, respectively, compared to 1.90% and 1.88% for the same periods in 2011 primarily due to continuing progress in repricing the core retail deposits and to the maturity of higher cost wholesale deposits during the period. The cost of borrowings decreased by 70 basis points to 2.17% and 55 basis points to 2.34% during the quarter and nine-month period ended September 30, 2012, respectively, compared to 2.87% and 2.89% for the same periods in 2011. The decrease in the cost of borrowing is attributable to the fact that in December 2011, as previously reported, \$600 million in repurchase agreements, with an average cost of 4.23%, matured. The Group paid off \$300 million of these repurchase agreements, and the remaining balance of \$300 million was renewed for an average period of approximately three and a half years at an effective fixed rate of 2.36%. To further reduce cost of borrowings, in May 2012, the Group renewed \$350 million in repurchase agreements, with an average cost of 4.26%, at a new effective rate of approximately 1.90%. During the quarter ended September 30, 2012, the Group initiated a plan to deleverage its balance sheet in connection with the BBVAPR Acquisition ahead of schedule by terminating repurchase agreements amounting to \$400 million with an average cost of 3.25%. Also, total borrowings decreased due to the repayment in March 2012, at maturity, of the TLGP notes.

For the quarter and nine-month period ended September 30, 2012, the average balance of total interest-earning assets was \$5.807 billion and \$5.870 billion, respectively, a decrease of 9.4% and 9.6% from the same periods in 2011. The decrease in average balance of interest-earning assets was mainly attributable to a 11.3% and 11.5% decrease for the quarter and nine-month period ended September 30, 2012, respectively, in average investments, in addition to a 4.3% and 4.6% decrease in average loans compared to the same periods in 2011 resulting from normal pay downs of covered loans and to the re-yielding of various pools of covered loans mainly during the second half of 2011. The decrease in the investment portfolio reflects a reduction in the available-for-sale portfolio, due to the sale of approximately \$1.090 billion in investment securities during the nine-month period ended September 30, 2012. As of September 30, 2012, the Group had \$515.5 million in cash and cash equivalents and \$270.0 million in securities purchased under agreements to resell, compared to \$591.5 million in cash and cash equivalents and no securities purchased under agreements to resell as of December 31, 2011.

For the quarter ended September 30, 2012, the average yield on interest-earning assets was 4.52% compared to 4.46% for the same period in 2011, and for the nine-month period ended September 30, 2012, it was 4.46% compared to 4.76% for the same period in 2011. This was mainly due to a decrease in the investment portfolio yield from 3.08% to 2.44% and from 3.79% to 2.50% for the quarter and nine-month period ended September 30, 2012, respectively. However, such decrease was partially offset by the higher average yields in the loan portfolio, mainly due to the covered loans that had an average yield of 20.38% and 18.50% for the quarter and nine-month period ended September 30, 2012, respectively, compared to 13.73% and 10.61% for the same periods in 2011.

## TABLE 2 - NON-INTEREST INCOME SUMMARY

|   | Quarter Ended September 30, |               |             | Nine-Month Period Ended September 30, |               |             |
|---|-----------------------------|---------------|-------------|---------------------------------------|---------------|-------------|
|   | 2012                        | 2011          | Variance    | 2012                                  | 2011          | Variance    |
|   | (Dollars in thousands)      |               |             |                                       |               |             |
| Wealth management revenues                          | \$ 6,042                    | \$ 5,387      | 12.2%       | \$ 17,835                             | \$ 14,644     | 21.8%       |
| Banking service revenues                            | 3,006                       | 2,969         | 1.2%        | 9,231                                 | 9,496         | -2.8%       |
| Mortgage banking activities                         | 2,204                       | 2,758         | -20.1%      | 7,142                                 | 7,017         | 1.8%        |
| <b>Total banking and wealth management revenues</b> | <b>11,252</b>               | <b>11,114</b> | <b>1.2%</b> | <b>34,208</b>                         | <b>31,157</b> | <b>9.8%</b> |
| Net amortization of FDIC shared-loss                |                             |               |             |                                       |               |             |
| indemnification asset                               | (8,096)                     | (2,422)       | -234.3%     | (18,505)                              | (191)         | -9588.5%    |

|  |                  |                  |               |                  |                  |             |
|--|------------------|------------------|---------------|------------------|------------------|-------------|
| Net gain (loss)                              |                  |                  |               |                  |                  |             |
| on:  |                  |                  |               |                  |                  |             |
| Sale of securities                           | 36,365           | 13,971           | 160.3%        | 55,703           | 23,102           | 141.1%      |
| Derivatives                                  | (1,326)          | (695)            | -90.8%        | (1,441)          | (8,392)          | 82.8%       |
| Foreclosed real estate                       | (1,209)          | (199)            | -507.5%       | (2,493)          | (334)            | -646.4%     |
| Early extinguishment of repurchase agreement | (24,312)         | (4,790)          | -407.6%       | (24,312)         | (4,790)          | -407.6%     |
| Other  | 978              | (14)             | 7085.7%       | 208              | 148              | 40.5%       |
|  | 2,400            | 5,851            | -59.0%        | 9,160            | 9,543            | -4.0%       |
| <b>Total non-interest income, net</b>        | <b>\$ 13,652</b> | <b>\$ 16,965</b> | <b>-19.5%</b> | <b>\$ 43,368</b> | <b>\$ 40,700</b> | <b>6.6%</b> |

### Non-Interest Income

Non-interest income is affected by the amount of securities, derivatives and trading transactions, the level of trust assets under management, transactions generated by clients' financial assets serviced by the securities broker-dealer and insurance subsidiaries, the level of mortgage banking activities, and the fees generated from loans and deposit accounts. It is also affected by the net amortization of the FDIC shared-loss indemnification asset, which varies depending on the results of the on-going evaluation of expected cash flows of the loan portfolio acquired in the FDIC-assisted acquisition of Eurobank.

As shown in Table 2 above, the Group recorded non-interest income in the amount of \$13.7 million and \$43.4 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to \$17.0 million and \$40.7 million for the same periods in 2011, a decrease of \$3.3 million and an increase of \$2.7 million, respectively.

The quarter ended September 30, 2012 includes \$36.4 million from the gain on sale of \$532.4 million securities, partially offset by an early extinguishment cost of \$24.3 million on \$400 million repurchase agreement funding. These transactions are part of our deleverage plan related to the BBVAPR Acquisition.

The net amortization of the FDIC shared-loss indemnification asset of \$8.1 million and \$18.5 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to net amortization of \$2.4 million and \$191 thousand for the same periods in 2011, resulted from the ongoing evaluation of expected cash flows of the covered loan portfolio, which resulted in reduced losses expected to be collected from the FDIC and the improved re-yielding of the accretable yield on the covered loans. The reduction in claimable losses amortizes the loss-share indemnification asset through the life of the shared loss agreement. This amortization is net of the accretion of the discount recorded to reflect the expected claimable loss at its net present value.

The losses related to derivatives increased approximately \$631 thousand and decreased \$7.0 million as compared to the quarter and nine-month period ended September 30, 2011, respectively.

Wealth management revenues, which consist of commissions and fees from fiduciary activities, and securities brokerage and insurance activities, increased 12.2% to \$6.0 million and 21.8% to \$17.8 million in the quarter and nine-month period ended September 30, 2012, respectively, from \$5.4 million and \$14.6 million for the same periods in 2011, due to increased brokerage, trust and insurance business and transactions.

Banking service revenues, which consist primarily of fees generated by deposit accounts, electronic banking services, and customer services, increased 1.2% to \$3.0 million in the quarter ended September 30, 2012 and decreased 2.8% to \$9.2 million in the nine-month period then ended, from \$3.0 million and \$9.5 million, respectively, for the same periods in 2011. This decrease for the nine-month period is attributable to a decrease in loan fees.

Income generated from mortgage banking activities decreased \$554 thousand in the quarter ended September 30, 2012 and increased 1.8% to \$7.1 million in the nine-month period then ended, compared to the same periods in 2011. Such increase is mainly a result of favorable pricing of mortgages sold into the secondary market.

### TABLE 3 - NON-INTEREST EXPENSES SUMMARY

|                                    | Quarter Ended September 30, |           |            | Nine-Month Period Ended September 30, |           |            |
|------------------------------------|-----------------------------|-----------|------------|---------------------------------------|-----------|------------|
|                                    | 2012                        | 2011      | Variance % | 2012                                  | 2011      | Variance % |
|                                    | (Dollars in thousands)      |           |            |                                       |           |            |
| Compensation and employee benefits | \$ 11,323                   | \$ 11,593 | -2.3%      | \$ 32,873                             | \$ 34,511 | -4.7%      |
| Professional and service fees      | 5,779                       | 5,308     | 8.9%       | 16,221                                | 16,506    | -1.7%      |
| Occupancy and equipment            | 4,169                       | 4,369     | -4.6%      | 12,624                                | 12,988    | -2.8%      |
| Insurance                          | 1,594                       | 1,302     | 22.4%      | 4,856                                 | 4,933     | -1.6%      |

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|  |                  |                  |             |                  |                  |              |
|--|------------------|------------------|-------------|------------------|------------------|--------------|
| Electronic banking charges                                 | 1,415            | 1,375            | 2.9%        | 4,581            | 3,984            | 15.0%        |
| Taxes, other than payroll and income taxes                 | 1,091            | 1,184            | -7.9%       | 2,158            | 3,422            | -36.9%       |
| Loan servicing and clearing expenses                       | 607              | 975              | -37.7%      | 2,530            | 3,072            | -17.6%       |
| Foreclosure and repossession expenses                      | 1,060            | 606              | 74.9%       | 2,745            | 1,659            | 65.5%        |
| Advertising, business promotion, and strategic initiatives | 1,594            | 1,686            | -5.5%       | 4,006            | 4,386            | -8.7%        |
| Communication  | 419              | 391              | 7.2%        | 1,246            | 1,212            | 2.8%         |
| Director and investors relations                           | 158              | 352              | -55.1%      | 809              | 977              | -17.2%       |
| Printing, postage, stationery and supplies                 | 299              | 292              | 2.4%        | 929              | 937              | -0.9%        |
| Other operating expenses                                   | 871              | 770              | 13.1%       | 2,428            | 2,661            | -8.8%        |
| <b>Total non-interest expenses</b>                         | <b>\$ 30,379</b> | <b>\$ 30,203</b> | <b>0.6%</b> | <b>\$ 88,006</b> | <b>\$ 91,248</b> | <b>-3.6%</b> |
| <b>Relevant ratios and data:</b>                           |                  |                  |             |                  |                  |              |
| Efficiency ratio   | <b>59.04%</b>    | <b>69.30%</b>    |             | <b>60.13%</b>    | <b>63.49%</b>    |              |
| Expense ratio  | <b>1.32%</b>     | <b>1.19%</b>     |             | <b>1.22%</b>     | <b>1.23%</b>     |              |
| Compensation and benefits to non-interest expense          | <b>37.27%</b>    | <b>38.38%</b>    |             | <b>37.35%</b>    | <b>37.82%</b>    |              |
| Compensation to total assets owned                         | <b>0.75%</b>     | <b>0.66%</b>     |             | <b>0.72%</b>     | <b>0.66%</b>     |              |
| Average number of employees                                | <b>755</b>       | <b>720</b>       |             | <b>750</b>       | <b>724</b>       |              |
|  | <b>\$ 60.0</b>   | <b>\$ 64.4</b>   |             | <b>\$ 58.4</b>   | <b>\$ 63.6</b>   |              |

Average  
compensation  
per employee

Assets  
owned per  
average  
employee

\$

**8,015 \$ 9,755**

\$

**8,068 \$ 9,701**

89

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## Non-Interest Expense

Non-interest expense for the quarter ended September 30, 2012 increased 0.6% to \$30.4 million, compared to \$30.2 million for the same period in 2011. For the nine-month period ended September 30, 2012, non-interest expense reached \$88.0 million, representing a decrease of 3.6% compared to \$91.2 million for the same period in 2011 as a result of the effective implementation of cost controls.

Taxes, other than payroll and income taxes, for the quarter and nine-month period ended September 30, 2012 decreased 7.9% to \$1.1 million and 36.9% to \$2.2 million, respectively, as compared to the same periods in 2011, principally due to the effect of the Eurobank integration, which for 2011 contemplated municipal license and property taxes for all of Eurobank's former facilities. In addition, during the nine-month period ended September 30, 2012, the Group recorded a municipal license benefit of \$1.4 million, attributed to a settlement reached with the municipality of San Juan during the second quarter of 2012, in which the Group paid \$60 thousand in full and final satisfaction of any and all claims for municipal license taxes for all fiscal years prior to and including 2011.

Compensation and employee benefits decreased 2.3% to \$11.3 million and 4.7% to \$32.9 million for the quarter and nine-month period ended September 30, 2012, respectively, from \$11.6 million and \$34.5 million for the same periods in 2011. The decrease is mostly related to an excess provision for bonus amounting to \$857 thousand compared to the amount finally paid during the first quarter of 2012, resulting in a benefit in the nine-month period ended September 30, 2012.

Insurance expense increased 22.4% and decreased 1.6% for the quarter and nine-month period ended September 30, 2012, respectively, as compared to the same periods in 2011. The decrease for the nine-month period ended September 30, 2012 is principally due to a change in FDIC assessment rates and a change in the methodology of the assessment applied to the Bank. The current methodology is based on average consolidated total assets less average tangible equity, instead of average total domestic deposits.

Loan servicing and clearing expenses and director and investment relations expenses decreased by 37.7% and 55.1%, respectively, in the quarter ended September 30, 2012 and 17.6% and 17.2%, respectively, in the nine-month period ended September 30, 2012.

Other expenses increased by 13.1% to \$871 thousand and professional and service fees by 8.9% to \$5.8 million for the quarter ended September 30, 2012, as compared to \$770 thousand and \$5.3 million for the same period in 2011, mainly due to cost associated with the BBVAPR Acquisition.



The increase in the Group's net-interest income resulted in a decrease in the efficiency ratio to 59.04% for the quarter ended September 30, 2012 compared to 69.30% for the quarter ended September 30, 2011, while it decreased to 60.13% for the nine-month period ended September 30, 2012 from 63.49% in the prior year. The efficiency ratio measures how much of a company's revenue is used to pay operating expenses. The Group computes its efficiency ratio by dividing non-interest expenses by the sum of its net interest income and non-interest income, but excluding gains on sale of investments securities, derivatives gains or losses, credit-related other-than-temporary impairment losses, net accretion or amortization of FDIC shared-loss indemnification assets, and other income that may be considered volatile in nature. Management believes that the exclusion of those items permits greater comparability. Amounts presented as part of non-interest income that are excluded from the efficiency ratio computation amounted to gains of \$2.4 million and \$9.2 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to gains of \$5.9 million and \$9.5 million for the quarter and nine-month period ended September 30, 2011. Revenues for purposes of the efficiency ratio for the quarter and nine-month period ended September 30, 2012 amounted to \$51.5 million and \$146.4 million, respectively, compared to \$43.6 million and \$143.7 million for the same periods in 2011.

### **Provision for Loan and Lease Losses**

The provision for non-covered loan and lease losses for the quarter ended September 30, 2012 decreased by \$200 thousand to \$3.6 million, and totaled \$10.4 million for the nine-month period ended September 30, 2012, an 8.8% decrease from the \$11.4 million reported for the same period in 2011. Based on an analysis of the credit quality and the composition of the Group's loan portfolio, management determined that the provision for the quarter and nine-month period ended September 30, 2012 was adequate in order to maintain the allowance for loan and lease losses at an adequate level to provide for probable losses based upon an evaluation of known and inherent risks. The Group's allowance for loan and lease losses policy provides for a detailed quarterly analysis of probable losses. The decrease in the provision for loan and lease losses for the nine-month period ended September 30, 2012 is supported by the following observed trends:

- Current loans to total gross loans increased from 85.7% at December 31, 2011 to 87.8% at September 30, 2012.

- Loans that are 90 days past due to total gross loans decreased from 10.6% at December 31, 2011 to 9.0% at September 30, 2012.
- Non-accruing loans decreased from \$134.8 million at December 31, 2011 to \$117.8 million at September 30, 2012.

During the quarter and nine-month period ended September 30, 2012, net credit losses amounted to \$1.9 million and \$8.3 million, respectively, a decrease of 12.9% and an increase of 19.1% when compared to \$2.2 million and \$7.0 million reported for the same periods in 2011. The decrease for the quarter ended September 30, 2012 is mainly due to a reduction in net credit losses for commercial and consumer loans of approximately \$501 thousand when compared to the same quarter in 2011. The increase for the nine-month period ended September 30, 2012 was primarily due to an increase in net credit losses for commercial loans of \$1.9 million when compared to the same period in 2011. Total charge-offs decreased 8.4% to \$2.1 million and increased 19.5% to \$8.7 million in the quarter and nine-month period ended September 30, 2012, respectively, as compared to the same periods in 2011, and total recoveries increased from \$121 thousand and \$331 thousand in the quarter and nine-month period ended September 30, 2011, respectively, to \$208 thousand and \$421 thousand in the quarter and nine-month period ended September 30, 2012, respectively. As a result, the recoveries to charge-offs ratio increased from 5.3% and 4.83% in the quarter and nine-month period ended September 30, 2011 to 9.95% and 4.83% in the quarter and nine-month period ended September 30, 2012.

The loans covered by the FDIC shared-loss agreement were recognized at fair value as of April 30, 2010, which included the impact of expected credit losses. To the extent credit deterioration occurs in covered loans after the date of acquisition, the Group would record an allowance for loan and lease losses. Also, the Group would record an increase in the FDIC share-loss indemnification asset for the expected reimbursement from the FDIC under the shared-loss agreements. As part of the Group's assessment of actual versus expected cash flows on covered loans during the nine-month period ended September 30, 2012, the Group observed that some pools of construction and development loans and commercial real estate loans underperformed. These observations required a provision for covered loan and lease losses of \$8.8 million, net of the effect from the FDIC shared-loss indemnification asset, for the nine-month period ended September 30, 2012, an increase from the recapture of covered loans and lease losses of (\$1.4) million for the same period in 2011.

Please refer to the "Allowance for Loan and Lease Losses and Non-Performing Assets" section in this MD&A and Table 8 through Table 13 below for more detailed information concerning the allowances for loan and lease losses, net credit losses and credit quality statistics.

## **Income Taxes**

Income tax expense was \$1.9 million and \$4.9 million for the quarter and nine-month period ended September 30, 2012, respectively, compared to an expense of \$580 thousand and \$5.7 million for the same periods in 2011. The

decrease during the nine-month period ended September 30, 2012 was mainly due to the re-measurement of the net deferred tax assets due to a reduction in the marginal corporate income tax rates from 40.95% to 30%, which was partially offset by the contingencies settled during the quarter ended June 30, 2011.

At December 31, 2011, OIB had \$2.9 million in the income tax effect of unrecognized gain on available-for-sale securities included in other comprehensive income. Following the change in OIB's applicable tax rate from 5% to 0% as a result of new Puerto Rico legislation adopted in 2011, this remaining tax balance will flow through income as these securities are repaid or sold in future periods. During the quarter and nine-month period ended September 30, 2012, income tax provision included \$1.1 million and \$1.8 million, respectively, related to this residual tax effect from the OIB.

**ANALYSIS OF FINANCIAL CONDITION****TABLE 4 - ASSETS SUMMARY AND COMPOSITION**

|  | September 30,<br>2012  | December 31,<br>2011 | Variance %    |
|--|------------------------|----------------------|---------------|
|  | (Dollars in thousands) |                      |               |
| <b>Investments:</b>  |                        |                      |               |
| FNMA and FHLMC certificates  | \$ 2,322,451           | \$ 3,560,806         | -34.8%        |
| Obligations of US Government sponsored agencies                                | 25,135                 | -                    | 100.0%        |
| US Treasury Securities   | 387,994                | -                    | 100.0%        |
| CMOs issued by US Government sponsored agencies                                | 307,367                | 130,045              | 136.4%        |
| GNMA certificates  | 18,732                 | 28,337               | -33.9%        |
| Structured credit investments  | 29,002                 | 37,288               | -22.2%        |
| Puerto Rico Government and agency obligations                                  | 22,354                 | 71,458               | -68.7%        |
| FHLB stock   | 22,865                 | 23,779               | -3.8%         |
| Other debt securities  | 15,599                 | 16,004               | -2.5%         |
| Other investments  | 1,583                  | 253                  | 525.7%        |
| <b>Total investments</b>   | <b>3,153,082</b>       | <b>3,867,970</b>     | <b>-18.5%</b> |
| <b>Loans:</b>  |                        |                      |               |
| Loans not covered under shared-loss agreements with the FDIC                   | 1,183,639              | 1,179,988            | 0.3%          |
| Allowance for loan and lease losses on non covered loans                       | (39,120)               | (37,010)             | -5.7%         |
| <b>Non covered loans receivable, net</b>                                       | <b>1,144,519</b>       | <b>1,142,978</b>     | <b>0.1%</b>   |
| Mortgage loans held for sale   | 38,211                 | 26,939               | 41.8%         |
| <b>Total loans not covered under shared-loss agreements with the FDIC, net</b> | <b>1,182,730</b>       | <b>1,169,917</b>     | <b>1.1%</b>   |
| Loans covered under shared-loss agreements with the FDIC                       | 470,453                | 533,532              | -11.8%        |
| Allowance for loan and lease losses on covered loans                           | (56,865)               | (37,256)             | -52.6%        |
| <b>Total loans covered under shared-loss agreements with the FDIC, net</b>     | <b>413,588</b>         | <b>496,276</b>       | <b>-16.7%</b> |
| <b>Total loans, net</b>  | <b>1,596,318</b>       | <b>1,666,193</b>     | <b>-4.2%</b>  |
| Securities purchased under agreements to resell                                | 270,000                | -                    | 100.0%        |
| <b>Total securities and loans</b>  | <b>5,019,400</b>       | <b>5,534,163</b>     | <b>-9.3%</b>  |
| <b>Other assets:</b>   |                        |                      |               |

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|   |                     |                     |               |
|---|---------------------|---------------------|---------------|
| Cash and due from banks                         | 511,478             | 587,624             | -13.0%        |
| Money market investments                        | 4,017               | 3,863               | 4.0%          |
| FDIC shared-loss indemnification asset          | 328,573             | 392,367             | -16.3%        |
| Foreclosed real estate                          | 39,400              | 27,679              | 42.3%         |
| Accrued interest receivable                     | 14,935              | 20,182              | -26.0%        |
| Deferred tax asset, net                         | 35,912              | 32,023              | 12.1%         |
| Premises and equipment, net                     | 19,268              | 21,520              | -10.5%        |
| Servicing assets                                | 10,642              | 10,454              | 1.8%          |
| Derivative assets                               | 18,495              | 9,317               | 98.5%         |
| Other assets                                    | 49,085              | 54,483              | -9.9%         |
| <b>Total other assets</b>                       | <b>1,031,805</b>    | <b>1,159,512</b>    | <b>-11.0%</b> |
| <b>Total assets</b>                             | <b>\$ 6,051,205</b> | <b>\$ 6,693,675</b> | <b>-9.6%</b>  |
| <b>Investments portfolio composition:</b>       |                     |                     |               |
| FNMA and FHLMC certificates                     | 73.7%               | 92.1%               |               |
| Obligations of US Government sponsored agencies | 0.8%                | 0.0%                |               |
| US Treasury Securities                          | 12.3%               | 0.0%                |               |
| CMOs issued by US Government sponsored agencies | 9.7%                | 3.4%                |               |
| GNMA certificates                               | 0.6%                | 0.7%                |               |
| Structured credit investments                   | 0.9%                | 1.0%                |               |
| Puerto Rico Government and agency obligations   | 0.7%                | 1.8%                |               |
| FHLB stock                                      | 0.7%                | 0.6%                |               |
| Other debt securities and other investments     | 0.6%                | 0.3%                |               |
|   | <b>100.0%</b>       | <b>99.9%</b>        |               |

## Assets Owned

At September 30, 2012, the Group's total assets amounted to \$6.051 billion, a decrease of 9.60% when compared to \$6.694 billion at December 31, 2011, and interest-earning assets decrease 9.3% from \$5.534 billion at December 31, 2011 to \$5.019 billion at September 30, 2012.

As set forth in Table 4 above, investments are the Group's largest components of interest-earning assets. Investments principally consist of U.S. treasury securities, U.S. government and agency bonds, mortgage-backed securities and Puerto Rico government and agency bonds. At September 30, 2012, the investment portfolio decreased 18.5% to \$3.153 billion from \$3.868 billion at December 31, 2011. This decrease is mostly due to the net effect of a decrease of \$1.238 billion in FNMA and FHLMC certificates and an increase in U.S. treasury securities of \$388.0 million. During the nine-month period ended September 30, 2012, the Group had net realized gains of \$55.7 million, mainly due to sales of mortgage-backed securities and CMOs of \$1.019 billion with a book value at sales of \$962.8 million. During the nine-month period ended September 30, 2011, the Group had gross realized gains of \$23.1 million, mainly due to sales of mortgage-backed securities of \$492.4 million with a book value at sales of \$469.3 million.

At September 30, 2012, approximately 97% of the Group's investment securities portfolio consists of fixed-rate mortgage-backed securities or notes guaranteed or issued by FNMA, FHLMC or GNMA, and U.S. agency senior debt obligations backed by a U.S. government-sponsored entity or the full faith and credit of the U.S. government, compared to 96% at December 31, 2011.

The Group's loan portfolio is comprised of residential loans, home equity loans, commercial loans collateralized by mortgages on real estate located in Puerto Rico, other commercial and industrial loans, consumer loans, and leases. At September 30, 2012, the Group's loan portfolio, the second largest category of the Group's interest-earning assets decreased 4.2% to \$1.596 billion compared to the loan portfolio of \$1.666 billion at December 31, 2011. The covered loan portfolio decreased \$82.7 million, or 16.7%, mainly due to an increase of \$19.6 million in the allowance for loan and lease losses on covered loans, and as a net effect of the repayment of loans and the portion of the accretable yield recognized as interest income. The non-covered loan portfolio increased \$12.8 million, or 1.1%.

At September 30, 2012, the Group's non-covered loan portfolio composition and trends were as follows:

- Mortgage loan portfolio amounted to \$771.7 million (65.0% of the gross non-covered loan portfolio), compared to \$821.1 million (69.3% of the gross non-covered loan portfolio) at December 31, 2011. Mortgage loan production and purchases totaled \$47.0 million and \$140.9 million for the quarter and nine-month period ended September 30,

2012, respectively, decreases of 10.8% from \$52.7 million and 14.7% from \$165.2 million in the quarter and nine-month period of the previous year, respectively.

- Commercial loan portfolio amounted to \$338.4 million (28.5% of the gross non-covered loan portfolio), compared to \$301.6 million (25.5% of the gross non-covered loan portfolio) at December 31, 2011. Commercial loan production increased 45.1% to \$43.6 million for the quarter ended September 30, 2012, and increased 46.0% to \$134.8 million for the nine-month period ended September 30, 2012 from \$30.0 million and \$92.3 million for the same periods in 2011.
- Consumer loan portfolio amounted to \$43.6 million (3.7% of the gross non-covered loan portfolio), compared to \$36.1 million (3.1% of the gross non-covered loan portfolio) at December 31, 2011. Consumer loan production increased 66.2% to \$9.5 million for the quarter ended September 30, 2012 and increased 48.8% to \$22.4 million for the nine-month period ended September 30, 2012 from \$5.7 million and \$15.0 million for the same periods in 2011.
- Leasing portfolio amounted to \$33.8 million (2.8% of the gross non-covered loan portfolio), compared to \$25.8 million (2.2% of the gross non-covered loan portfolio) at December 31, 2011. Leasing production increased 12.9% to \$6.3 million for the quarter ended September 30, 2012 but decreased 5.6% to \$15.2 million for the nine-month period ended September 30, 2012 from \$5.6 million and \$16.1 million for the same periods in 2011.

The FDIC shared-loss indemnification asset amounted to \$328.6 million as of September 30, 2012 and \$392.4 million as of December 31, 2011. The FDIC shared-loss indemnification asset is reduced as claims over losses recognized on covered loans are collected from the FDIC. Realized credit losses in excess of previously forecasted estimates result in an increase in the FDIC shared-loss indemnification asset. Conversely, if realized credit losses are less than previously forecasted estimates, the FDIC shared-loss indemnification asset is amortized through the term of the shared-loss agreements. The decrease in the FDIC shared-loss indemnification asset is mainly related to reimbursements received from the FDIC during the nine-month period ended September 30, 2012 of \$63.3 million and amortization of \$18.5 million, which was partially offset by an increase of \$10.8 million in expected credit impairment losses to be covered under shared-loss agreements, net and \$7.2 million in incurred expenses to be reimbursed under the shared-loss agreements.

**TABLE 5 — LOANS RECEIVABLE COMPOSITION**

|  | September 30,<br>2012 | December 31,<br>2011 | Variance<br>% |
|--|-----------------------|----------------------|---------------|
|  | (In thousands)        |                      |               |
| <b>Loans not covered under shared-loss agreements with FDIC:</b>           |                       |                      |               |
| <b>Loans secured by real estate:</b>                                       |                       |                      |               |
| Residential  | \$ 770,979            | \$ 819,651           | -5.9%         |
| Home equity loans and others   | 768                   | 1,411                | -45.6%        |
| Commercial   | 239,654               | 218,261              | 9.8%          |
| Deferred loan fees, net  | (3,962)               | (4,300)              | 7.9%          |
| <b>Total loans secured by real estate</b>                                  | <b>1,007,439</b>      | <b>1,035,023</b>     | <b>-2.7%</b>  |
| <b>Other loans:</b>  |                       |                      |               |
| Commercial   | 98,710                | 83,312               | 18.5%         |
| Personal consumer loans and credit lines                                   | 43,631                | 36,130               | 20.8%         |
| Leasing  | 33,772                | 25,768               | 31.1%         |
| Deferred loan costs (fees), net  | 87                    | (245)                | 135.5%        |
| Total other loans  | 176,200               | 144,965              | 21.5%         |
| <b>Loans receivable</b>  | <b>1,183,639</b>      | <b>1,179,988</b>     | <b>0.3%</b>   |
| Allowance for loan and lease losses on non-covered loans                   | (39,120)              | (37,010)             | -5.7%         |
| <b>Loans receivable, net</b>   | <b>1,144,519</b>      | <b>1,142,978</b>     | <b>0.1%</b>   |
| Mortgage loans held-for-sale   | 38,211                | 26,939               | 41.8%         |
| <b>Total loans not covered under shared-loss agreements with FDIC, net</b> | <b>1,182,730</b>      | <b>1,169,917</b>     | <b>1.1%</b>   |
| <b>Loans covered under shared-loss agreements with FDIC:</b>               |                       |                      |               |
| Loans secured by 1-4 family residential properties                         | 138,138               | 140,824              | -1.9%         |



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|   |                     |                     |               |
|---|---------------------|---------------------|---------------|
| Construction and development<br>secured by 1-4 family residential<br>properties | 7,933               | 16,976              | -53.3%        |
| Commercial and other construction   | 301,383             | 325,832             | -7.5%         |
| Leasing   | 12,140              | 36,122              | -66.4%        |
| Consumer  | 10,859              | 13,778              | -21.2%        |
| <b>Total loans covered under<br/>shared-loss agreements with FDIC</b>           | <b>470,453</b>      | <b>533,532</b>      | <b>-11.8%</b> |
| Allowance for loan and lease<br>losses on covered loans                         | (56,865)            | (37,256)            | -52.6%        |
| <b>Total loans covered under<br/>shared-loss agreements with FDIC,<br/>net</b>  | <b>413,588</b>      | <b>496,276</b>      | <b>-16.7%</b> |
| <b>Total loans receivable, net</b>  | <b>\$ 1,596,318</b> | <b>\$ 1,666,193</b> | <b>-4.2%</b>  |

TABLE 6 - LIABILITIES SUMMARY AND COMPOSITION

|   | September 30,<br>2012 |  | December 31,<br>2011 | Variance<br>% |
|---|-----------------------|--|----------------------|---------------|
| (Dollars in thousands)                                |                       |  |                      |               |
| <b>Deposits:</b>                                      |                       |  |                      |               |
| Non-interest bearing deposits                         | \$ 197,664            |  | \$ 192,256           | 2.8%          |
| NOW accounts  | 850,735               |  | 850,762              | 0.0%          |
| Savings and money market accounts                     | 250,952               |  | 230,672              | 8.8%          |
| Certificates of deposit                               | 912,674               |  | 1,157,002            | -21.1%        |
| <b>Total deposits</b>                                 | <b>2,212,025</b>      |  | <b>2,430,692</b>     | <b>-9.0%</b>  |
| Accrued interest payable                              | 2,342                 |  | 4,493                | -47.9%        |
| <b>Total deposits and accrued interest payable</b>    | <b>2,214,367</b>      |  | <b>2,435,185</b>     | <b>-9.1%</b>  |
| <b>Borrowings:</b>                                    |                       |  |                      |               |
| Securities sold under agreements to repurchase        | 2,652,366             |  | 3,056,238            | -13.2%        |
| Advances from FHLB                                    | 285,395               |  | 281,753              | 1.3%          |
| FDIC-guaranteed term notes                            | -                     |  | 105,834              | -100.0%       |
| Subordinated capital notes                            | 36,083                |  | 36,083               | 0.0%          |
| <b>Total borrowings</b>                               | <b>2,973,844</b>      |  | <b>3,479,908</b>     | <b>-14.5%</b> |
| <b>Total deposits and borrowings</b>                  | <b>5,188,211</b>      |  | <b>5,915,093</b>     | <b>-12.3%</b> |
| Derivative liabilities                                | 58,269                |  | 47,425               | 22.9%         |
| Other liabilities                                     | 33,038                |  | 35,602               | -7.2%         |
| <b>Total liabilities</b>                              | <b>\$ 5,279,518</b>   |  | <b>\$ 5,998,120</b>  | <b>-12.0%</b> |
| <b>Deposits portfolio composition percentages:</b>    |                       |  |                      |               |
| Non-interest bearing deposits                         | 8.9%                  |  | 7.9%                 |               |
| NOW accounts  | 38.5%                 |  | 35.0%                |               |
| Savings and money market accounts                     | 11.3%                 |  | 9.5%                 |               |
| Certificates of deposit                               | 41.3%                 |  | 47.6%                |               |
|   | <b>100.0%</b>         |  | <b>100.0%</b>        |               |
| <b>Borrowings portfolio composition percentages:</b>  |                       |  |                      |               |
| Securities sold under agreements to repurchase        | 89.2%                 |  | 87.9%                |               |
| Advances from FHLB                                    | 9.6%                  |  | 8.1%                 |               |
| FDIC-guaranteed term notes                            | 0.0%                  |  | 3.0%                 |               |
| Subordinated capital notes                            | 1.2%                  |  | 1.0%                 |               |
|   | <b>100.0%</b>         |  | <b>100.0%</b>        |               |
| <b>Securities sold under agreements to repurchase</b> |                       |  |                      |               |
| Amount outstanding at quarter-end                     | \$ 2,652,366          |  | \$ 3,056,238         |               |
| Daily average outstanding balance                     | \$ 3,047,605          |  | \$ 3,445,167         |               |
| Maximum outstanding balance at any month-end          | \$ 3,060,578          |  | \$ 3,466,480         |               |



## **Liabilities and Funding Sources**

As shown in Table 6 above, at September 30, 2012, the Group's total liabilities were \$5.280 billion, 12.0% lower than the \$5.998 billion reported at December 31, 2011. Deposits and borrowings, the Group's funding sources, amounted to \$5.188 billion at September 30, 2012 versus \$5.915 billion at December 31, 2011, a 12.3% decrease.

At September 30, 2012, borrowings represented 57.3% of interest-bearing liabilities and deposits represented 42.7%. Borrowings consist mainly of funding sources through the use of repurchase agreements, FHLB advances, and subordinated capital notes. At September 30, 2012, borrowings amounted to \$2.974 billion, 14.5% lower than the \$3.480 billion reported at December 31, 2011. The TLGP notes totaling \$105 million were repaid in full at maturity in March 2012. Repurchase agreements as of September 30, 2012 decreased approximately \$403.9 million to \$2.652 billion from \$3.056 billion at December 31, 2011, mainly due to the early termination of repurchase agreements amounting to \$400 million during the quarter ended September 30, 2012.

As a member of the FHLB, the Bank can obtain advances from the FHLB, secured by the FHLB stock owned by the Bank, as well as by certain of the Bank's mortgage loans and investment securities. Advances from FHLB amounted to \$285.4 million and \$281.8 million as of September 30, 2012 and December 31, 2011, respectively. These advances mature from October 2012 through April 2017.

At September 30, 2012, deposits and accrued interest payable, the second largest category of the Group's interest-bearing liabilities, were \$2.214 billion, down 9.1% from \$2.435 billion at December 31, 2011. This decrease was mainly attributable to a decrease in higher cost brokered deposits and other wholesale institutional deposits which decreased 44.8% and 56.2%, respectively, to \$141.3 million and \$73.7 million as of September 30, 2012 from \$255.9 million and \$168.3 million as of December 31, 2011.

## **Stockholders' Equity**

At September 30, 2012, the Group's total stockholders' equity was \$771.7 million, a 10.9% increase when compared to \$695.6 million at December 31, 2011. The increase reflects the issuance of the Convertible Preferred Stock during the quarter ended September 30, 2012 amounting to \$84 million and a decrease of 75.6% or \$28.1 million in other comprehensive income, partially offset by the net income for the nine-month period ended September 30, 2012.

Tangible common equity to risk-weighted assets and total equity to risk-weighted assets at September 30, 2012 increased to 32.96% and 40.79%, respectively, from 30.14% and 33.48% at December 31, 2011.

The Group maintains capital ratios in excess of regulatory requirements. At September 30, 2012, Tier 1 Leverage Capital Ratio was 10.91% (2.73 times the requirement of 4.00%), Tier 1 Risk-Based Capital Ratio was 36.33% (9.08 times the requirement of 4.00%), and Total Risk-Based Capital Ratio was 37.63% (4.70 times the requirement of 8.00%).

Taking into consideration our strong capital position, we increased the quarterly cash dividend per common share by 20.0% to \$0.06 per share on November 30, 2011. On an annualized basis, this represents an increase from \$0.20 to \$0.24 per share.

The following are the consolidated capital ratios of the Group at September 30, 2012 and December 31, 2011:

**TABLE 7 — CAPITAL, DIVIDENDS AND STOCK DATA**

|  | <b>September 30,<br/>2012</b>                        |            | <b>December 31,<br/>2011</b> | <b>Variance<br/>%</b> |       |
|--|--|------------|------------------------------|-----------------------|-------|
|  | <b>(Dollars in thousands, except per share data)</b> |            |                              |                       |       |
| <b>Capital data:</b>                             |  |            |                              |                       |       |
| Stockholders' equity                             | \$   | 771,687    | \$                           | 695,555               | 10.9% |
| <b>Regulatory Capital Ratios data:</b>           |  |            |                              |                       |       |
| Leverage capital ratio                           |  | 10.91%     |                              | 9.65%                 | 13.0% |
| Minimum leverage capital ratio required          |  | 4.00%      |                              | 4.00%                 |       |
| Actual tier 1 capital                            | \$   | 687,436    | \$                           | 661,614               | 3.9%  |
| Minimum tier 1 capital required                  | \$   | 252,145    | \$                           | 274,230               | -8.1% |
| Excess over regulatory requirement               | \$   | 435,291    | \$                           | 387,384               | 12.4% |
| Tier 1 risk-based capital ratio                  |  | 36.33%     |                              | 31.84%                | 14.1% |
| Minimum tier 1 risk-based capital ratio required |  | 4.00%      |                              | 4.00%                 |       |
| Actual tier 1 risk-based capital                 | \$   | 687,436    | \$                           | 661,614               | 3.9%  |
| Minimum tier 1 risk-based capital required       | \$   | 75,681     | \$                           | 83,110                | -8.9% |
| Excess over regulatory requirement               | \$   | 611,755    | \$                           | 578,504               | 5.7%  |
| Risk-weighted assets                             | \$   | 1,892,021  | \$                           | 2,077,742             | -8.9% |
| Total risk-based capital ratio                   |  | 37.63%     |                              | 33.12%                | 13.6% |
| Minimum total risk-based capital ratio required  |  | 8.00%      |                              | 8.00%                 |       |
| Actual total risk-based capital                  | \$   | 711,987    | \$                           | 688,188               | 3.5%  |
| Minimum total risk-based capital required        | \$   | 151,362    | \$                           | 166,219               | -8.9% |
| Excess over regulatory requirement               | \$   | 560,625    | \$                           | 521,969               | 7.4%  |
| Risk-weighted assets                             | \$   | 1,892,021  | \$                           | 2,077,742             | -8.9% |
| Tangible common equity to total assets           |  | 10.30%     |                              | 9.36%                 | 10.0% |
| Tangible common equity to risk-weighted assets   |  | 32.96%     |                              | 30.14%                | 9.4%  |
| Total equity to total assets                     |  | 12.75%     |                              | 10.39%                | 22.7% |
| Total equity to risk-weighted assets             |  | 40.79%     |                              | 33.48%                | 21.8% |
| Tier 1 common equity to risk-weighted assets     |  | 31.03%     |                              | 27.01%                | 14.9% |
| Tier 1 common equity capital                     | \$   | 587,098    | \$                           | 561,275               | 4.6%  |
| <b>Stock data:</b>                               |  |            |                              |                       |       |
| Outstanding common shares                        |  | 40,745,946 |                              | 41,244,533            | -1.2% |
| Book value per common share                      | \$   | 15.40      | \$                           | 15.28                 | 0.8%  |

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|  |    |         |    |         |        |
|--|----|---------|----|---------|--------|
| Market price at end of period          | \$ | 10.52   | \$ | 12.11   | -13.1% |
| Market capitalization at end of period | \$ | 428,647 | \$ | 499,471 | -14.2% |

**Nine-Month Period Ended**  
**September 30,**  
**2012                      2011**  
**(Dollars in thousands, except per share data)**

**Common dividend data:**

|                                   |    |             |             |  | <b>Variance</b> |
|-----------------------------------|----|-------------|-------------|--|-----------------|
|                                   |    | <b>2012</b> | <b>2011</b> |  | <b>%</b>        |
| Cash dividends declared           | \$ | 7,331       | \$ 6,677    |  | 9.8%            |
| Cash dividends declared per share | \$ | 0.18        | \$ 0.15     |  | 20.0%           |
| Payout ratio                      |    | 19.60%      | 16.02%      |  | 22.3%           |
| Dividend yield                    |    | 2.28%       | 2.07%       |  | 10.3%           |

The table that follows presents a reconciliation of the Group's total stockholders' equity to tangible common equity and total assets to tangible assets at September 30, 2012 and December 31, 2011:

|  | <b>September<br/>30,<br/>2012</b>                                    | <b>December 31,<br/>2011</b> |
|--|--|------------------------------|
|  | <b>(In thousands, except share<br/>or per<br/>share information)</b> |                              |
| Total stockholders' equity                       | \$ 771,687   | \$ 695,555                   |
| Preferred stock                                  | (152,000)  | (68,000)                     |
| Preferred stock issuance costs                   | 7,639  | 2,662                        |
| Goodwill   | (2,701)  | (2,701)                      |
| Core deposit intangible                          | (1,079)  | (1,185)                      |
| <b>Total tangible common equity</b>              | <b>\$ 623,546</b>  | <b>\$ 626,331</b>            |
| Total assets                                     | 6,051,205  | 6,693,675                    |
| Goodwill   | (2,701)  | (2,701)                      |
| Core deposit intangible                          | (1,079)  | (1,185)                      |
| <b>Total tangible assets</b>                     | <b>\$,047,425</b>  | <b>\$ 6,689,789</b>          |
| <b>Tangible common equity to tangible assets</b> | <b>10.31%</b>  | <b>9.36%</b>                 |
| Common shares outstanding at end of period       | 40,745,946   | 41,244,533                   |
| <b>Tangible book value per common share</b>      | <b>\$ 15.30</b>  | <b>\$ 15.19</b>              |

The tangible common equity ratio and tangible book value per common share are non-GAAP measures. Management and many stock analysts use the tangible common equity ratio and tangible book value per common share in conjunction with more traditional bank capital ratios to compare the capital adequacy of banking organizations. Neither tangible common equity nor tangible assets or related measures should be considered in isolation or as a substitute for stockholders' equity, total assets or any other measure calculated in accordance with GAAP. Moreover, the manner in which the Group calculates its tangible common equity, tangible assets and any other related measures may differ from that of other companies reporting measures with similar names.

The Tier 1 common equity to risk-weighted assets ratio is another non-GAAP measure. Ratios calculated based upon Tier 1 common equity have become a focus of regulators and investors, and management believes ratios based on Tier 1 common equity assist investors in analyzing the Group's capital position. In connection with the Supervisory Capital Assessment Program, the Federal Reserve Board began supplementing its assessment of the capital adequacy of a bank holding company based on a variation of Tier 1 capital, known as Tier 1 common equity.



Because Tier 1 common equity is not formally defined by GAAP or, unlike Tier 1 capital, codified in the federal banking regulations, this measure is considered to be a non-GAAP financial measure. Non-GAAP financial measures have inherent limitations, are not required to be uniformly applied and are not audited. To mitigate these limitations, the Group has procedures in place to calculate these measures using the appropriate GAAP or regulatory components. Although these non-GAAP financial measures are frequently used by stakeholders in the evaluation of a company, they have limitations as analytical tools and should not be considered in isolation or as a substitute for analyses of results as reported under GAAP.

The table below presents a reconciliation of the Group's total common equity (GAAP) at September 30, 2012 and December 31, 2011 to Tier 1 common equity (non-GAAP):

|  | <b>September<br/>30,<br/>2012</b> | <b>December<br/>31,<br/>2011</b> |
|--|-----------------------------------|----------------------------------|
|  | <b>(In thousands)</b>             |                                  |
| Common stockholders' equity  | \$627,326                         | \$ 630,216                       |
| Unrealized gains on available-for-sale securities, net of income tax | (60,098)                          | (79,244)                         |
| Unrealized losses on cash flow hedges, net of income tax             | 51,035                            | 42,113                           |
| Disallowed deferred tax assets                                       | (26,322)                          | (26,879)                         |
| Disallowed servicing assets  | (1,064)                           | (1,045)                          |
| Intangible assets:   |                                   |                                  |
| Goodwill   | (2,701)                           | (2,701)                          |
| Other disallowed intangibles   | (1,079)                           | (1,185)                          |
| <b>Total Tier 1 common equity</b>                                    | <b>\$587,097</b>                  | <b>\$ 561,275</b>                |
| <b>Tier 1 common equity to risk-weighted assets</b>                  | <b>31.03%</b>                     | <b>27.01%</b>                    |

The following table presents the Group's capital adequacy information at September 30, 2012 and December 31, 2011:

|  | <b>September<br/>30,<br/>2012</b> | <b>December<br/>31,<br/>2011</b> |
|--|-----------------------------------|----------------------------------|
|  | <b>(In thousands)</b>             |                                  |
| Risk-based capital:                    |                                   |                                  |
| Tier 1 capital                         | \$687,436                         | \$ 661,614                       |
| Supplementary (Tier 2) capital         | 24,551                            | 26,574                           |
| <b>Total Capital</b>                   | <b>\$711,987</b>                  | <b>\$ 688,188</b>                |
| Risk-weighted assets:                  |                                   |                                  |
| Balance sheet items                    | \$835,653                         | \$ 2,032,982                     |
| Off-balance sheet items                | 56,368                            | 44,760                           |
| <b>Total risk-weighted assets</b>      | <b>\$892,021</b>                  | <b>\$ 2,077,742</b>              |
| Ratios:                                |                                   |                                  |
| Tier 1 capital (minimum required - 4%) | 36.33%                            | 31.84%                           |
| Total capital (minimum required - 8%)  | 37.63%                            | 33.12%                           |
| Leverage ratio                         | 10.91%                            | 9.65%                            |
| Equity to assets                       | 12.75%                            | 10.39%                           |
| Tangible common equity to assets       | 10.30%                            | 9.36%                            |

The Federal Reserve Board has risk-based capital guidelines for bank holding companies. Under the guidelines, the minimum ratio of qualifying total capital to risk-weighted assets is 8%. At least half of the total capital is to be comprised of qualifying common stockholders' equity, qualifying noncumulative perpetual preferred stock (including related surplus), minority interests related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary, and restricted core capital elements (collectively "Tier 1 Capital"). Banking organizations are expected to maintain at least 50% of their Tier 1 Capital as common equity. Except as otherwise discussed below in light of the Dodd-Frank Act in connection with certain debt or equity instruments issued on or after May 19, 2010, not more than 25% of qualifying Tier 1 Capital may consist of qualifying cumulative perpetual preferred stock, trust preferred securities or other so-called restricted core capital elements. "Tier 2 Capital" may consist, subject to certain limitations, of allowance for loan and lease losses; perpetual preferred stock and related surplus; hybrid capital instruments, perpetual debt, and mandatory convertible debt securities; term subordinated debt and intermediate-term preferred stock, including related surplus; and unrealized holding gains on equity securities. "Tier 3 Capital" consists of qualifying unsecured subordinated debt.

The sum of Tier 2 and Tier 3 Capital may not exceed the amount of Tier 1 Capital. At September 30, 2012 and December 31, 2011, the Group was a "well capitalized" institution for regulatory purposes.

The Federal Reserve Board has regulations with respect to risk-based and leverage capital ratios that require most intangibles, including goodwill and core deposit intangibles, to be deducted from Tier 1 Capital. The only types of identifiable intangible assets

that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships.

In addition, the Federal Reserve Board has established minimum leverage ratio (Tier 1 Capital to total assets) guidelines for bank holding companies and member banks. These guidelines provide for a minimum leverage ratio of 3% for bank holding companies and member banks that meet certain specified criteria, including that they have the highest regulatory rating. All other bank holding companies and member banks are required to maintain a minimum ratio of Tier 1 Capital to total assets of 4%. The guidelines also provide that banking organizations experiencing internal growth or making acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Furthermore, the guidelines state that the Federal Reserve Board will continue to consider a "tangible Tier 1 leverage ratio" and other indicators of capital strength in evaluating proposals for expansion or new activities.

Under the Dodd-Frank Act, federal banking regulators are required to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured institutions, depository institution holding companies, and non-bank financial companies supervised by the Federal Reserve Board. The minimum leverage and risk based capital requirements are to be determined based on the minimum ratios established for insured depository institutions under prompt corrective action regulations. In effect, such provision of the Dodd-Frank Act (i.e., Section 171), which is commonly known as the Collins Amendment, applies to bank holding companies the same leverage and risk based capital requirements that apply to insured depository institutions. Because the capital requirements must be the same for insured depository institutions and their holding companies, the Collins Amendment generally excludes certain debt or equity instruments, such as cumulative perpetual preferred stock and trust preferred securities, from Tier 1 Capital, subject to a three-year phase-out from Tier 1 qualification for such instruments issued before May 19, 2010, with the phase-out commencing on January 1, 2013. However, such instruments issued before May 19, 2010 by a bank holding company, such as the Group, with total consolidated assets of less than \$15 billion as of December 31, 2009, are not affected by the Collins Amendment and may continue to be included in Tier 1 Capital as a restricted core capital element.

On June 12, 2012, the Office of the Comptroller of the Currency (the "OCC"), the Federal Reserve Board, and the FDIC issued three notices of proposed rulemaking ("NPRs") that would revise and replace the agencies' current capital rules. The agencies also announced the finalization of the market risk capital rule that was proposed in 2011.

In the first Basel III NPR, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions" (the "Basel III NPR"), the agencies are proposing to revise their risk-based and leverage capital requirements consistent with agreements reached by the Basel Committee on Banking Supervision ("Basel III"). The Basel III NPR would apply to all insured banks and savings associations, top-tier bank holding companies domiciled in the United States with more than \$500 million in assets, and savings and loan holding companies that are domiciled in the United States. Provisions of the Basel III NPR that would apply to such banking organizations include implementation of a new common equity Tier 1 minimum capital requirement, a higher minimum Tier 1 capital requirement, and, for banking organizations subject to the advanced

approaches capital rules, a supplementary leverage ratio that incorporates a broader set of exposures. Additionally, consistent with Basel III, the agencies propose to apply limits on a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a specified "buffer" of common equity Tier 1 capital in addition to the minimum risk-based capital requirements. The revisions set forth in the Basel III NPR are consistent with Section 171 of the Dodd-Frank Act, which requires the agencies to establish minimum risk-based and leverage capital requirements.

The Basel III NPR also would revise the agencies' prompt corrective action framework by incorporating the new regulatory capital minimums and updating the definition of tangible common equity. Prompt corrective action is an enforcement framework that constrains the activities of insured depository institutions based on their level of regulatory capital.

The second Basel III NPR, "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule" (the "Advanced Approaches and Market Risk NPR"), would revise the advanced approaches risk-based capital rules consistent with Basel III and other changes to the Basel Committee's capital standards. The agencies also propose revising the advanced approaches risk-based capital rules to be consistent with Section 939A and Section 171 of the Dodd-Frank Act. Additionally in the Advanced Approaches and Market Risk NPR, the OCC and the FDIC propose that the market risk capital rules apply to federal and state savings associations, and the Federal Reserve Board proposes that the advanced approaches and market risk capital rules apply to top-tier savings and loan holding companies domiciled in the United States, if stated thresholds for trading activity are met. Generally, the advanced approaches rules would apply to such institutions with \$250 billion or more in consolidated assets or \$10 billion or more in foreign exposure, and the market risk rule would apply to savings and loan holding companies with significant trading activity.

In the third capital NPR, “Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements” (the “Standardized Approach NPR”), the agencies propose to revise and harmonize rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses identified over recent years, including by incorporating aspects of the Basel II standardized framework, and alternatives to credit ratings, consistent with Section 939A of the Dodd-Frank Act. The revisions include methods for determining risk-weighted assets for residential mortgages, securitization exposures, and counterparty credit risk. The Standardized Approach NPR also would introduce disclosure requirements that would apply to U.S. banking organizations with \$50 billion or more in total assets. The Standardized Approach NPR would apply to the same set of institutions as the Basel III NPR.

The Group’s common stock is traded on the New York Stock Exchange (“NYSE”) under the symbol “OFG.” At September 30, 2012 and December 31, 2011, the Group’s market capitalization for its outstanding common stock was \$428.6 million (\$10.52 per share) and \$499.5 million (\$12.11 per share), respectively.

The following table provides the high and low prices and dividends per share of the Group’s common stock for each quarter of the last three calendar years:

|                    |    | Price |          | Cash Dividend |
|--------------------|----|-------|----------|---------------|
|                    |    | High  | Low      | Per share     |
| <b>2012</b>        |    |       |          |               |
| September 30, 2012 | \$ | 11.49 | \$ 10.02 | \$ 0.06       |
| June 30, 2012      | \$ | 12.37 | \$ 9.87  | \$ 0.06       |
| March 31, 2012     | \$ | 12.69 | \$ 11.25 | \$ 0.06       |
| <b>2011</b>        |    |       |          |               |
| December 31, 2011  | \$ | 12.35 | \$ 9.19  | \$ 0.06       |
| September 30, 2011 | \$ | 13.20 | \$ 9.18  | \$ 0.05       |
| June 30, 2011      | \$ | 13.07 | \$ 11.26 | \$ 0.05       |
| March 31, 2011     | \$ | 12.84 | \$ 11.40 | \$ 0.05       |
| <b>2010</b>        |    |       |          |               |
| December 31, 2010  | \$ | 13.72 | \$ 11.50 | \$ 0.05       |
| September 30, 2010 | \$ | 14.45 | \$ 12.13 | \$ 0.04       |
| June 30, 2010      | \$ | 16.72 | \$ 12.49 | \$ 0.04       |
| March 31, 2010     | \$ | 14.09 | \$ 10.00 | \$ 0.04       |

The Bank is considered “well capitalized” under the regulatory framework for prompt corrective action. The table below shows the Bank’s regulatory capital ratios at September 30, 2012 and at December 31, 2011:

|   | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> | <b>Variance<br/>%</b> |
|---|-------------------------------|------------------------------|-----------------------|
|   | <b>(Dollars in thousands)</b> |                              |                       |
| <b>Oriental Bank and Trust Regulatory Capital Ratios:</b> |                               |                              |                       |
| <b>Total Tier 1 Capital to Total Assets</b>               | <b>10.66%</b>                 | <b>9.06%</b>                 | <b>17.7%</b>          |
| Actual tier 1 capital                                     | \$ 660,838                    | \$ 616,590                   | 7.2%                  |
| Minimum capital requirement (4%)                          | \$ 247,862                    | \$ 272,177                   | -8.9%                 |
| Minimum to be well capitalized (5%)                       | \$ 309,827                    | \$ 340,221                   | -8.9%                 |
| <b>Tier 1 Capital to Risk-Weighted Assets</b>             | <b>35.47%</b>                 | <b>29.79%</b>                | <b>19.1%</b>          |
| Actual tier 1 risk-based capital                          | \$ 660,838                    | \$ 616,590                   | 7.2%                  |
| Minimum capital requirement (4%)                          | \$ 74,525                     | \$ 82,787                    | -10.0%                |
| Minimum to be well capitalized (6%)                       | \$ 111,787                    | \$ 124,180                   | -10.0%                |
| <b>Total Capital to Risk-Weighted Assets</b>              | <b>36.77%</b>                 | <b>31.07%</b>                | <b>18.3%</b>          |
| Actual total risk-based capital                           | \$ 685,032                    | \$ 643,065                   | 6.5%                  |
| Minimum capital requirement (8%)                          | \$ 149,049                    | \$ 165,573                   | -10.0%                |
| Minimum to be well capitalized (10%)                      | \$ 186,311                    | \$ 206,967                   | -10.0%                |

### Group’s Financial Assets Managed

The Group’s financial assets managed include those managed by the Group’s trust division, retirement plan administration subsidiary, and Oriental Financial Services. Assets managed by the trust division and Oriental Financial Services increased from \$4.142 billion as of December 31, 2011 to \$4.617 billion as of September 30, 2012, mainly as a result of an increase in account contributions and capital market appreciation.

The Group’s trust division offers various types of IRAs and manages 401(k) and Keogh retirement plans and custodian and corporate trust accounts, while the retirement plan administration subsidiary, CPC, manages private retirement plans. At September 30, 2012, total assets managed by the Group’s trust division and CPC amounted to \$2.450 billion, compared to \$2.216 billion at December 31, 2011. Oriental Financial Services offers a wide array of investment alternatives to its client base, such as tax-advantaged fixed income securities, mutual funds, stocks, bonds and money management wrap-fee programs. At September 30, 2012, total assets gathered by Oriental Financial Services from its customer investment accounts increased to \$2.167 billion, compared to \$1.926 billion at December 31, 2011.

### Allowance for Loan and Lease Losses and Non-Performing Assets

The Group maintains an allowance for loan and lease losses at a level that management considers adequate to provide for probable losses based upon an evaluation of known and inherent risks. The Group's allowance for loan and lease losses policy provides for a detailed quarterly analysis of probable losses. Tables 8 through 13 set forth an analysis of activity in the allowance for loan and lease losses and present selected loan loss statistics. In addition, refer to Table 5 for the composition of the loan portfolio.

**Non-covered Loans**

At September 30, 2012, the Group's allowance for non-covered loan and lease losses amounted to \$39.1 million or 3.29% of total non-covered loans versus \$37.0 million, or 3.12%, of total non-covered loans at December 31, 2011. The allowance for residential mortgage loans, consumer loans, and leases decreased by 2.8% (or \$599 thousand), 17.5% (or \$249 thousand), and 71.1% (or \$601 thousand), respectively, when compared with balances recorded at December 31, 2011. The allowance for commercial loans increased by 23.0%, or \$2.9 million, when compared with balances recorded at December 31, 2011. The unallocated allowance increased by 123.2%, or \$668 thousand, when compared with balances recorded at December 31, 2011.

Please refer to the "Provision for Loan and Lease Losses" section in this MD&A for a more detailed analysis of provisions for loan and lease losses.



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 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 losses charged to current operations is based on such methodology. Loan losses are charged and recoveries are credited to the allowance for loan and lease losses.

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 and 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 market value. The portfolios of mortgage loans, leases and consumer loans are considered homogeneous, and are evaluated collectively for impairment. For the commercial loans portfolio, all loans over \$250 thousand that are either over 90 days past due or adversely classified, or when deemed necessary by management, are evaluated for impairment. At September 30, 2012, the total investment in impaired commercial loans was \$35.9 million, compared to \$46.4 million at December 31, 2011. Most of the impaired commercial loans are measured based on the fair value of collateral method, since most impaired loans during the period were collateral dependent, all other loans are measured using the present value of cash flows method. The valuation allowance for impaired commercial loans amounted to approximately \$1.3 million and \$3.5 million at September 30, 2012 and December 31, 2011, respectively. At September 30, 2012, the total investment in impaired mortgage loans was \$64.9 million, compared to \$51.5 million at December 31, 2011. Impairment on mortgage loans assessed as troubled-debt restructuring was measured using the present value of cash flows. The valuation allowance for impaired mortgage loans amounted to approximately \$4.8 million and \$3.4 million at September 30, 2012 and December 31, 2011.

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: 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, and 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 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 collateral value. The

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

Loan loss ratios and credit risk categories are updated quarterly and are applied in the context of GAAP and the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses, which requires that depository institutions have prudent, conservative, but not excessive loan loss allowances that fall within an acceptable range of estimated losses. While management uses available information in estimating probable loan losses, future changes to the allowance may be necessary, based on factors beyond the Group's control, such as factors affecting general economic conditions.

There have been no material changes in criteria or estimation techniques as compared to prior periods that impacted the determination of the current period allowance for loan and lease losses, except for the further segregation of the traditional residential mortgage portfolio by origination vintages made since the June 30, 2012 quarter. The new segregation allows management to perform more efficient assessment of the traditional mortgage portfolio historical losses and risk. Also, since the quarter ended June 30, 2012, the following changes were made to the current environmental factors consider for the determination of the allowance for loan and lease losses:

- consolidation of national and local economic trends and industry conditions as one factor;
- the addition of the quality of the Bank's loan review system as graded in the last FDIC report of examination to the factor dealing with management's experience, ability, and depth of lending management and other relevant staff; and
- the addition of the changes in the value of underlying collateral for collateral dependant loans.

The Group's non-performing assets include non-performing loans and foreclosed real estate (see Tables 11 and 12). At September 30, 2012 and December 31, 2011, the Group had \$117.8 million and \$134.8 million, respectively, of non-accrual non-covered loans including credit cards accounted under ASC 310-20, a decrease of 12.56%. Covered loans are considered to be performing due to the application of the accretion method under ASC 310-30. At September 30, 2012 and December 31, 2011, loans whose terms have been extended and which are classified as troubled-debt restructuring that are not included in non-performing assets amounted to \$56.6 million and \$41.3 million, respectively.

At September 30, 2012, the Group's non-performing assets decreased 8.58% to \$136.9 million (2.44% of total assets, excluding covered loans) from \$149.8 million (2.42% of total assets, excluding covered loans) at December 31, 2011. The decrease in the Group's non-performing loans generally reflects the ongoing stabilization of the economic environment in Puerto Rico. The Group does not expect non-performing loans to result in significantly higher losses as most are well-collateralized with adequate loan-to-value ratios. At September 30, 2012, the allowance for non-covered loan and lease losses to non-performing loans coverage ratio was 33.20% (27.46% at December 31, 2011).

The Group follows a conservative residential mortgage lending policy, with more than 90% of its residential mortgage portfolio consisting of fixed-rate, fully amortizing, fully documented loans that do not have the level of risk associated with subprime loans offered by certain major U.S. mortgage loan originators. Furthermore, the Group has never been active in negative amortization loans or adjustable rate mortgage loans, including those with teaser rates, and does not originate construction and development loans.

The following items comprise non-performing assets:

- Mortgage loans — are placed on non-accrual status when they become 90 days or more past due and are written-down, if necessary, based on the specific evaluation of the collateral underlying the loan. At September 30, 2012, the Group's non-performing mortgage loans totaled \$87.9 million (74.6% of the Group's non-performing loans), a 9.70% decrease from \$97.3 million (72.2% of the Group's non-performing loans) at December 31, 2011. Non-performing loans in this category are primarily residential mortgage loans. 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. The interest receivable on such loans is evaluated on a periodic basis against the collateral underlying the loans, and written-down, if necessary. 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.

- Commercial loans — are placed on non-accrual status when they become 90 days or more past due and are written-down, if necessary, based on the specific evaluation of the underlying collateral, if any. At September 30, 2012, the Group's non-performing commercial loans amounted to \$29.6 million (25.2% of the Group's non-performing loans), a 19.84% decrease when compared to non-performing commercial loans of \$37.0 million at December 31, 2011 (27.4% of the Group's non-performing loans). Approximately 72% of this portfolio is collateralized by commercial real estate properties.
- Consumer loans — are placed on non-accrual status when they become 90 days past due and written-off when payments are delinquent 120 days in personal loans and 180 days in credit cards and personal lines of credit. At September 30, 2012, the Group's non-performing consumer loans amounted to \$276 thousand (0.2% of the Group's total non-performing loans), a 17.4% decrease from \$334 thousand at December 31, 2011 (0.3% of total non-performing loans).
- Leases — are placed on non-accrual status when they become 90 days past due and partially written-off to collateral value when payments are delinquent 120 days, and fully written-off when payments are delinquent 180 days. At September 30, 2012, the Group's non-performing leases amounted to \$11 thousand (0.01% of the Group's total non-performing loans), a decrease of 89.22% from \$102 thousand at December 31, 2011 (0.1% of total non-performing loans).
- Foreclosed real estate — is initially recorded at the lower of the related loan balance or fair value less cost to sell as of the date of foreclosure. Any excess of the loan balance over the fair value of the property is charged against the allowance for loan and lease losses. Subsequently, any excess of the carrying value over the estimated fair value less disposition cost is charged to operations. Net losses on the sale of foreclosed real estate for the quarter and nine-month period ended September 30, 2012, amounted to \$1.2

million and \$2.5 million, respectively, compared to \$199 thousand and \$334 thousand in the quarter and nine-month period ended September 30, 2011.

The Group has two mortgage loan modification programs. These are the Loss Mitigation Program and the Non-traditional Mortgage Loan Program. Both programs are intended to help responsible homeowners to remain in their homes and avoid foreclosure, while also reducing the Group's losses on non-performing mortgage loans.

The Loss Mitigation Program helps mortgage borrowers who are or will become financially unable to meet the current or scheduled mortgage payments. Loans that qualify under this program are those guaranteed by FHA, VA, RHS, "Banco de la Vivienda de Puerto Rico," conventional loans guaranteed by Mortgage Guaranty Insurance Corporation (MGIC), conventional loans sold to the FNMA and FHLMC, and conventional loans retained by the Group. The program offers diversified alternatives such as regular or reduced payment plans, payment moratorium, mortgage loan modification, partial claims (only FHA), short sale, and payment in lieu of foreclosure.

The Non-traditional Mortgage Loan Program is for non-traditional mortgages, including balloon payment, interest only/interest first, variable interest rate, adjustable interest rate and other qualified loans. Non-traditional mortgage loan portfolios are segregated into the following categories: performing loans that meet secondary market requirement and are refinanced by the credit underwriting guidelines of FHA/VA/FNMA/FMAC, and performing loans not meeting secondary market guidelines, processed by the Group's current credit and underwriting guidelines. The Group achieved an affordable and sustainable monthly payment by taking specific, sequential, and necessary steps such as reducing the interest rate, extending the loan term, capitalizing arrearages, deferring the payment of principal or, if the borrower qualifies, refinancing the loan.

There may not be a foreclosure sale scheduled within 60 days prior to a loan modification under any such programs. This requirement does not apply to loans where the foreclosure process has been stopped by the Group. In order to apply for any of the loan modification programs, the borrower may not be in active bankruptcy or have been discharged from Chapter 7 bankruptcy since the loan was originated. Loans in these programs will be evaluated by management for troubled debt restructuring classification if the Group grants a concession for legal or economic reasons due to the debtor's financial difficulties.

### **Covered Loans**

The allowance for loan and lease losses on covered loans acquired in the FDIC-assisted acquisition of Eurobank is accounted under the provisions of ASC 310-30. Under this accounting guidance, the allowance for loan and lease losses on covered loans is evaluated at each financial reporting period, based on forecasted cash flows. Credit related decreases in expected cash flows, compared to those 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.

As part of the evaluation of actual versus expected cash flows, the Group assesses on a quarterly basis the credit quality of these loans based on delinquency, severity factors and risk ratings, among other assumptions. The credit quality assumptions for certain pools were updated to reflect an increase in default rates, severities and extension of recovery lags resulting in an increase in the provision for covered loan and lease losses of \$221 thousand for the quarter ended September 30, 2012. Such increase in provision was net of the effect of the increase in the FDIC shared-loss indemnification asset. As a result, the allowance for covered loans increased from \$37.3 million at December 31, 2011 to \$56.9 million at September 30, 2012.

**TABLE 8 — ALLOWANCE FOR LOAN AND LEASE LOSSES SUMMARY**

|   | Quarter Ended September 30, |                  | Variance<br>% | Nine-Month Period Ended<br>September 30, |                  | Variance<br>% |
|---|-----------------------------|------------------|---------------|--|------------------|---------------|
|   | 2012                        | 2011             |               | 2012                                     | 2011             |               |
|   | (Dollars in thousands)      |                  |               | (Dollars in thousands)                   |                  |               |
| <b><u>Non-covered</u></b>                     |                             |                  |               |  |                  |               |
| <b><u>loans</u></b>                           |                             |                  |               |  |                  |               |
| <b>Balance at beginning of period</b>         | \$ 37,402                   | \$ 34,229        | 9.3%          | \$ 37,010                                | \$ 31,430        | 17.8%         |
| Provision for non-covered                     |                             |                  |               |  |                  |               |
| loan and lease losses                         | 3,600                       | 3,800            | -5.3%         | 10,400                                   | 11,400           | -8.8%         |
| Charge-offs                                   | (2,090)                     | (2,281)          | -8.4%         | (8,711)                                  | (7,292)          | 19.5%         |
| Recoveries                                    | 208                         | 121              | 71.9%         | 421                                      | 331              | 27.2%         |
| <b>Balance at end of period</b>               | \$ <b>39,120</b>            | \$ <b>35,869</b> | <b>9.1%</b>   | \$ <b>39,120</b>                         | \$ <b>35,869</b> | <b>9.1%</b>   |
| <b>Allowance for loans and lease</b>          |                             |                  |               |  |                  |               |
| <b>losses to:</b>                             |                             |                  |               |  |                  |               |
| Total loans, excluding                        |                             |                  |               |  |                  |               |
| covered loans                                 | <b>3.29%</b>                | <b>3.08%</b>     | <b>6.8%</b>   |  |                  |               |
| Non-performing loans, excluding covered loans | <b>33.21%</b>               | <b>27.08%</b>    | <b>22.6%</b>  |  |                  |               |
| <b><u>Covered loans</u></b>                   |                             |                  |               |  |                  |               |
| <b>Balance at beginning of period</b>         | \$ 58,628                   | \$ 53,036        | 10.5%         | \$ 37,256                                | \$ 49,286        | -24.4%        |
| Provision for (recapture of) covered          |                             |                  |               |  |                  |               |
| loan and lease losses, net                    | 221                         | (1,936)          | -111.4%       | 8,845                                    | (1,387)          | -737.7%       |

FDIC  
shared-loss  
portion on

provision  
for (recapture  
of) loan

and lease  
losses

**Balance at end  
of period**     \$

|               |               |              |               |               |              |
|---------------|---------------|--------------|---------------|---------------|--------------|
| (1,984)       | (13,860)      | -85.7%       | 10,764        | (10,659)      | -201.0%      |
| <b>56,865</b> | <b>37,240</b> | <b>52.7%</b> | <b>56,865</b> | <b>37,240</b> | <b>52.7%</b> |



**TABLE 9 — ALLOWANCE FOR NON-COVERED LOAN AND LEASE LOSSES BREAKDOWN**

|   | September 30,<br>2012  |  | December 31,<br>2011 | Variance<br>% |
|---|------------------------|--|----------------------|---------------|
|   | (Dollars in thousands) |  |                      |               |
| <b>Allowance balance:</b>                                       |                        |  |                      |               |
| Mortgage  | \$ 21,053              |  | \$ 21,652            | -2.8%         |
| Commercial  | 15,439                 |  | 12,548               | 23.0%         |
| Consumer  | 1,174                  |  | 1,423                | -17.5%        |
| Leasing   | 244                    |  | 845                  | -71.1%        |
| Unallocated allowance   | 1,210                  |  | 542                  | 123.2%        |
| <b>Total allowance balance</b>                                  | <b>\$ 39,120</b>       |  | <b>\$ 37,010</b>     | <b>5.7%</b>   |
| <b>Allowance composition:</b>                                   |                        |  |                      |               |
| Mortgage  | 53.82%                 |  | 58.52%               | -8.0%         |
| Commercial  | 39.47%                 |  | 33.90%               | 16.4%         |
| Consumer  | 3.00%                  |  | 3.84%                | -21.9%        |
| Leasing   | 0.62%                  |  | 2.28%                | -72.8%        |
| Unallocated allowance   | 3.09%                  |  | 1.46%                | 111.6%        |
|   | <b>100.00%</b>         |  | <b>100.00%</b>       |               |
| <b>Allowance coverage ratio at end of period applicable to:</b> |                        |  |                      |               |
| Mortgage  | 2.73%                  |  | 2.64%                | 3.4%          |
| Commercial  | 4.56%                  |  | 4.16%                | 9.6%          |
| Consumer  | 2.64%                  |  | 3.79%                | -30.3%        |
| Leasing   | 0.72%                  |  | 3.28%                | -78.0%        |
| Unallocated allowance to total loans                            | 0.10%                  |  | 0.05%                | 100.0%        |
| <b>Total allowance to total loans, excluding covered loans</b>  | <b>3.29%</b>           |  | <b>3.12%</b>         | <b>5.4%</b>   |
| <b>Allowance coverage ratio to non-performing loans:</b>        |                        |  |                      |               |
| Mortgage  | 23.95%                 |  | 22.32%               | 7.3%          |
| Commercial  | 52.07%                 |  | 33.92%               | 53.5%         |
| Consumer  | 462.20%                |  | 216.59%              | 113.4%        |
| Leasing   | 2218.18%               |  | 828.43%              | 167.8%        |
| <b>Total</b>  | <b>33.21%</b>          |  | <b>27.46%</b>        | <b>20.9%</b>  |

**TABLE 10 — NET CREDIT LOSSES STATISTICS ON NON-COVERED LOAN AND LEASES**

|  | Quarter Ended September 30, |                |               | Variance<br>%  | Nine-Month Period Ended<br>September 30, |               |  | Variance<br>% |
|--|-----------------------------|----------------|---------------|----------------|--|---------------|--|---------------|
|  | 2012                        | 2011           |               |                | 2012                                     | 2011          |  |               |
|  | (In thousands)              |                |               |                | (In thousands)                           |               |  |               |
| <b>Mortgage</b>  |                             |                |               |                |  |               |  |               |
| Charge-offs  | \$ (1,752)                  | \$ (1,391)     | 26.0%         | \$ (4,621)     | \$ (4,480)                               | 3.1%          |  |               |
| Recoveries   | 131                         | -              | -             | 131            | 45                                       | 191.1%        |  |               |
| <b>Total</b>   | <b>(1,621)</b>              | <b>(1,391)</b> | <b>16.5%</b>  | <b>(4,490)</b> | <b>(4,435)</b>                           | <b>1.2%</b>   |  |               |
| <b>Commercial</b>                                      |                             |                |               |                |  |               |  |               |
| Charge-offs  | (65)                        | (440)          | -85.2%        | (3,423)        | (1,478)                                  | 131.6%        |  |               |
| Recoveries   | 28                          | 56             | -50.0%        | 129            | 108                                      | 19.4%         |  |               |
| <b>Total</b>   | <b>(37)</b>                 | <b>(384)</b>   | <b>-90.4%</b> | <b>(3,294)</b> | <b>(1,370)</b>                           | <b>140.4%</b> |  |               |
| <b>Consumer</b>  |                             |                |               |                |  |               |  |               |
| Charge-offs  | (198)                       | (368)          | -46.2%        | (563)          | (1,160)                                  | -51.5%        |  |               |
| Recoveries   | 46                          | 63             | -27.0%        | 153            | 175                                      | -12.6%        |  |               |
| <b>Total</b>   | <b>(152)</b>                | <b>(305)</b>   | <b>-50.2%</b> | <b>(410)</b>   | <b>(985)</b>                             | <b>-58.4%</b> |  |               |
| <b>Leasing</b>   |                             |                |               |                |  |               |  |               |
| Charge-offs  | (75)                        | (82)           | -8.5%         | (104)          | (174)                                    | -40.2%        |  |               |
| Recoveries   | 3                           | 2              | 50.0%         | 8              | 3  | 166.7%        |  |               |
| <b>Total</b>   | <b>(72)</b>                 | <b>(80)</b>    | <b>-10.0%</b> | <b>(96)</b>    | <b>(171)</b>                             | <b>-43.9%</b> |  |               |
| <b>Net credit losses</b>                               |                             |                |               |                |  |               |  |               |
| Total charge-offs                                      | (2,090)                     | (2,281)        | -8.4%         | (8,711)        | (7,292)                                  | 19.5%         |  |               |
| Total recoveries                                       | 208                         | 121            | 71.9%         | 421            | 331                                      | 27.2%         |  |               |
| <b>Total</b>   | <b>(1,882)</b>              | <b>(2,160)</b> | <b>-12.9%</b> | <b>(8,290)</b> | <b>(6,961)</b>                           | <b>19.1%</b>  |  |               |
| <b>Net credit losses to average loans outstanding:</b> |                             |                |               |                |  |               |  |               |
| Mortgage   | 0.80%                       | 0.64%          | 24.9%         | 0.73%          | 0.67%                                    | 8.3%          |  |               |
| Commercial   | 0.05%                       | 0.59%          | -92.1%        | 1.42%          | 0.75%                                    | 90.4%         |  |               |
| Consumer   | 1.43%                       | 3.57%          | -59.8%        | 1.37%          | 4.10%                                    | -66.7%        |  |               |
| Leasing  | 0.92%                       | 1.72%          | -46.8%        | 0.44%          | 1.53%                                    | -71.3%        |  |               |
| <b>Total</b>   | <b>0.63%</b>                | <b>0.73%</b>   | <b>-14.3%</b> | <b>0.92%</b>   | <b>0.79%</b>                             | <b>16.2%</b>  |  |               |
| <b>Recoveries to charge-offs</b>                       | <b>9.95%</b>                | <b>5.30%</b>   | <b>87.6%</b>  | <b>4.83%</b>   | <b>4.54%</b>                             | <b>6.5%</b>   |  |               |
| <b>Average loans not covered under</b>                 |                             |                |               |                |  |               |  |               |

**shared-loss  
agreements**

**with the  
FDIC:**

|              |           |                  |           |                  |             |           |                  |           |                  |             |
|--------------|-----------|------------------|-----------|------------------|-------------|-----------|------------------|-----------|------------------|-------------|
| Mortgage     | \$        | 808,949          | \$        | 866,947          | -6.7%       | \$        | 822,116          | \$        | 879,463          | -6.5%       |
| Commercial   |           | 317,888          |           | 260,932          | 21.8%       |           | 309,373          |           | 245,053          | 26.2%       |
| Consumer     |           | 42,382           |           | 34,188           | 24.0%       |           | 39,993           |           | 32,019           | 24.9%       |
| Leasing      |           | 31,426           |           | 18,584           | 69.1%       |           | 29,126           |           | 14,906           | 95.4%       |
| <b>Total</b> | <b>\$</b> | <b>1,200,645</b> | <b>\$</b> | <b>1,180,651</b> | <b>1.7%</b> | <b>\$</b> | <b>1,200,608</b> | <b>\$</b> | <b>1,171,441</b> | <b>2.5%</b> |

TABLE 11 — NON-PERFORMING ASSETS

|  | September 30,<br>2012  |  | December 31,<br>2011 | Variance<br>(%) |
|--|------------------------|--|----------------------|-----------------|
|  | (Dollars in thousands) |  |                      |                 |
| <b>Non-performing assets:</b>  |                        |  |                      |                 |
| Non-accruing loans   |                        |  |                      |                 |
| Troubled Debt Restructuring loans                                      | \$ 27,055              |  | \$ 27,533            | -1.7%           |
| Other loans  | 90,777                 |  | 107,231              | -15.3%          |
| Total non-performing loans   | \$ 117,832             |  | \$ 134,764           | -12.6%          |
| Foreclosed real estate not covered under the                           |                        |  |                      |                 |
| shared-loss agreements with the FDIC                                   | 17,765                 |  | 13,812               | 28.6%           |
| Other repossessed assets not covered under                             |                        |  |                      |                 |
| the shared-loss agreement with the FDIC                                | 97                     |  | -                    | 100.0%          |
| Mortgage loans held for sale in non-accrual                            | 1,247                  |  | 1,223                | 2.0%            |
|  | \$ <b>136,941</b>      |  | \$ <b>149,799</b>    | <b>-8.6%</b>    |
| <b>Non-performing assets to total assets, excluding covered assets</b> | <b>2.44%</b>           |  | <b>2.42%</b>         | <b>0.8%</b>     |
| <b>Non-performing assets to total capital</b>                          | <b>17.75%</b>          |  | <b>21.54%</b>        | <b>-17.6%</b>   |

|  | Quarter Ended September 30, |          | Nine-Month Period Ended |          |
|--|-----------------------------|----------|-------------------------|----------|
|  | 2012                        | 2011     | September 30,           | 2011     |
|  | (In thousands)              |          |                         |          |
| <b>Interest that would have been recorded in the period if the</b> |                             |          |                         |          |
| <b>loans had not been classified as non-accruing loans</b>         |                             |          |                         |          |
|  | \$ 1,597                    | \$ 1,654 | \$ 4,147                | \$ 4,152 |

TABLE 12 — NON-PERFORMING LOANS

|                              | September 30,<br>2012  |  | December 31,<br>2011 | Variance<br>% |
|------------------------------|------------------------|--|----------------------|---------------|
|                              | (Dollars in thousands) |  |                      |               |
| <b>Non-performing loans:</b> |                        |  |                      |               |

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|   |           |                |           |                |               |
|---|-----------|----------------|-----------|----------------|---------------|
| Mortgage  | \$        | 87,896         | \$        | 97,340         | -9.7%         |
| Commercial  |           | 29,649         |           | 36,988         | -19.8%        |
| Consumer  |           | 276            |           | 334            | -17.4%        |
| Leasing   |           | 11             |           | 102            | -89.2%        |
| <b>Total</b>  | <b>\$</b> | <b>117,832</b> | <b>\$</b> | <b>134,764</b> | <b>-12.6%</b> |
| <b>Non-performing loans composition percentages:</b>            |           |                |           |                |               |
| Mortgage  |           | 74.6%          |           | 72.2%          |               |
| Commercial  |           | 25.2%          |           | 27.4%          |               |
| Consumer  |           | 0.2%           |           | 0.3%           |               |
| Leasing   |           | 0.0%           |           | 0.1%           |               |
| <b>Total</b>  |           | <b>100.0%</b>  |           | <b>100.0%</b>  |               |
| <b>Non-performing loans to:</b>                                 |           |                |           |                |               |
| Total loans, excluding covered loans                            |           | <b>9.96%</b>   |           | <b>11.42%</b>  | <b>-12.8%</b> |
| Total assets, excluding covered assets                          |           | <b>2.10%</b>   |           | <b>2.18%</b>   | <b>-3.7%</b>  |
| Total capital   |           | <b>15.27%</b>  |           | <b>19.38%</b>  | <b>-21.2%</b> |
| <b>Non-performing loans with partial charge-offs to:</b>        |           |                |           |                |               |
| Total loans, excluding covered loans                            |           | <b>3.07%</b>   |           | <b>2.77%</b>   | <b>10.8%</b>  |
| Non-performing loans, excluding covered loans                   |           | <b>30.89%</b>  |           | <b>24.45%</b>  | <b>26.3%</b>  |
| <b>Other non-performing loans ratios:</b>                       |           |                |           |                |               |
| Charge-off rate on non-performing loans to non-performing loans |           |                |           |                |               |
| on which charge-offs have been taken, excluding covered loans   |           | <b>29.59%</b>  |           | <b>23.73%</b>  | <b>24.7%</b>  |
| Allowance for loan and lease losses to non-performing loans on  |           |                |           |                |               |
| which no charge-offs have been taken, excluding covered loans   |           | <b>48.04%</b>  |           | <b>36.35%</b>  | <b>32.2%</b>  |

**TABLE 13 — HIGHER RISK RESIDENTIAL MORTGAGE LOANS**

| <b>September 30, 2012</b>                      |   |                  |                 |   |                  |                 |   |                  |                 |
|--|---|------------------|-----------------|---|------------------|-----------------|---|------------------|-----------------|
| <b>Higher-Risk Residential Mortgage Loans*</b> |   |                  |                 |   |                  |                 |   |                  |                 |
|  | <b>Junior Lien Mortgages<br/>Carrying</b> |                  |                 | <b>Interest Only Loans<br/>Carrying</b> |                  |                 | <b>High Loan-to-Value<br/>Ratio Mortgages<br/>LTV 90% and over<br/>Carrying</b> |                  |                 |
|  | <b>Value</b>                              | <b>Allowance</b> | <b>Coverage</b> | <b>Value</b>                            | <b>Allowance</b> | <b>Coverage</b> | <b>Value</b>  | <b>Allowance</b> | <b>Coverage</b> |
|  | <b>(In thousands)</b>                     |                  |                 |   |                  |                 |   |                  |                 |
| <b><u>Delinquency:</u></b>                     |   |                  |                 |   |                  |                 |   |                  |                 |
| 0 - 89 days                                    | \$ 15,753                                 | \$ 262           | 1.66%           | \$ 28,891                               | \$ 600           | 2.08%           | \$ 74,743   | \$ 1,804         | 2.41%           |
| 90 - 119 days                                  | 393                                       | 6                | 1.53%           | 164                                     | 4                | 2.44%           | 170   | 18               | 10.59%          |
| 120 - 179 days                                 | 114                                       | 10               | 8.77%           | -                                       | -                | 0.00%           | 1,538   | 111              | 7.22%           |
| 180 - 364 days                                 | 961                                       | 72               | 7.49%           | 1,064                                   | 144              | 13.53%          | 3,149   | 261              | 8.29%           |
| 365+ days                                      | 1,537                                     | 243              | 15.81%          | 3,503                                   | 802              | 22.89%          | 10,040  | 1,576            | 15.70%          |
| Total  | \$ 18,758                                 | \$ 593           | 3.16%           | \$ 33,622                               | \$ 1,550         | 4.61%           | \$ 89,640   | \$ 3,770         | 4.21%           |
| Percentage of total loans not covered          |   |                  |                 |   |                  |                 |   |                  |                 |
| by FDIC shared-loss agreements                 | 1.54%                                     |                  |                 | 2.75%                                   |                  |                 | 7.34%   |                  |                 |
| <b><u>Refinanced or Modified Loans:</u></b>    |   |                  |                 |   |                  |                 |   |                  |                 |
| Amount   | \$ 2,525                                  | \$ 243           | 9.62%           | \$ -                                    | \$ -             | 0.00%           | \$ 17,941   | \$ 1,558         | 8.68%           |
| Percentage of Higher-Risk Loan                 |   |                  |                 |   |                  |                 |   |                  |                 |
| Category                                       | 13.46%                                    |                  |                 | 0.00%                                   |                  |                 | 20.01%  |                  |                 |
| <b><u>Loan-to-Value Ratio:</u></b>             |   |                  |                 |   |                  |                 |   |                  |                 |
| Under 70%                                      | \$ 14,133                                 | \$ 405           | 2.87%           | \$ 5,064                                | \$ 168           | 3.32%           | \$ -  | \$ -             | -               |
| 70% - 79%                                      | 2,966                                     | 51               | 1.72%           | 7,340                                   | 477              | 6.50%           | -   | -                | -               |
| 80% - 89%                                      | 1,060                                     | 39               | 3.68%           | 8,673                                   | 341              | 3.93%           | -   | -                | -               |
| 90% and over                                   | 599                                       | 98               | 16.36%          | 12,545                                  | 564              | 4.50%           | 89,640  | 3,770            | 4.21%           |
|  | \$ 18,758                                 | \$ 593           | 3.16%           | \$ 33,622                               | \$ 1,550         | 4.61%           | \$ 89,640   | \$ 3,770         | 4.21%           |

\* Loans may be included in more than one higher-risk loan category.



### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### **Background**

The Group's risk management policies are established by its Board of Directors (the "Board") and implemented by management through the adoption of a risk management program, which is overseen and monitored by the Chief Risk Officer and the Risk Management and Compliance Committee. The Group has continued to refine and enhance its risk management program by strengthening policies, processes and procedures necessary to maintain effective risk management.

All aspects of the Group's business activities are susceptible to risk. Consequently, risk identification and monitoring are essential to risk management. As more fully discussed below, the Group's primary risk exposures include, market, interest rate, credit, liquidity, operational and concentration risks.

#### **Market Risk**

Market risk is the risk to earnings or capital arising from adverse movements in market rates or prices, such as interest rates or prices. The Group evaluates market risk together with interest rate risk. The Group's financial results and capital levels are constantly exposed to market risk. The Board and management are primarily responsible for ensuring that the market risk assumed by the Group complies with the guidelines established by policies approved by the Board. The Board has delegated the management of this risk to the Asset/Liability Management Committee ("ALCO") which is composed of certain executive officers from the business, treasury and finance areas. One of ALCO's primary goals is to ensure that the market risk assumed by the Group is within the parameters established in such policies.

#### **Interest Rate Risk**

Interest rate risk is the exposure of the Group's earnings or capital to adverse movements in interest rates. It is a predominant market risk in terms of its potential impact on earnings. The Group manages its asset/liability position in order to limit the effects of changes in interest rates on net interest income. ALCO oversees interest rate risk, liquidity management and other related matters.

In discharging its responsibilities, ALCO examines current and expected conditions in world financial markets, competition and prevailing rates in the local deposit market, liquidity, unrealized gains and losses in securities, recent or proposed changes to the investment portfolio, alternative funding sources and their costs, hedging and the possible



purchase of derivatives such as swaps, and any tax or regulatory issues which may be pertinent to these areas.

On a monthly basis, the Group performs a net interest income simulation analysis on a consolidated basis to estimate the potential change in future earnings from projected changes in interest rates. These simulations are carried out over a one-year time horizon, assuming certain gradual upward and downward interest rate movements, achieved during a twelve-month period. Simulations are carried out in two ways:

- (1) using a static balance sheet as the Group had on the simulation date, and
- (2) using a dynamic balance sheet based on recent growth patterns and business strategies.

The balance sheet is divided into groups of assets and liabilities detailed by maturity or re-pricing and their corresponding interest yields and costs. As interest rates rise or fall, these simulations incorporate expected future lending rates, current and expected future funding sources and costs, the possible exercise of options, changes in prepayment rates, deposits decay and other factors which may be important in projecting the future growth of net interest income.

The Group uses a software application to project future movements in the Group's balance sheet and income statement. The starting point of the projections generally corresponds to the actual values of the balance sheet on the date of the simulations.

These simulations are highly complex, and use many simplifying assumptions that are intended to reflect the general behavior of the Group over the period in question. There can be no assurance that actual events will match these assumptions in all cases. For this reason, the results of these simulations are only approximations of the true sensitivity of net interest income to changes in market interest rates. The following table presents the results of the simulations at September 30, 2012 for the most likely scenario, assuming a one-year time horizon:

|                                       | <b>Net Interest Income Risk (one year projection)</b> |                           |                               |                           |                           |        |
|---------------------------------------|---|---------------------------|-------------------------------|---------------------------|---------------------------|--------|
|                                       | <b>Static Balance Sheet</b>                           |                           |                               | <b>Growing Simulation</b> |                           |        |
|                                       | <b>Amount<br/>Change</b>                              | <b>Percent<br/>Change</b> |                               | <b>Amount<br/>Change</b>  | <b>Percent<br/>Change</b> |        |
| <b><u>Change in interest rate</u></b> |   |                           | <b>(Dollars in thousands)</b> |                           |                           |        |
| + 200 Basis points                    | \$  | 14,241                    | 9.76%                         | \$                        | 12,546                    | 8.91%  |
| + 100 Basis points                    | \$  | 7,429                     | 5.09%                         | \$                        | 6,636                     | 4.71%  |
| - 50 Basis points                     | \$  | (4,280)                   | -2.93%                        | \$                        | (3,997)                   | -2.84% |

The impact of -100 and -200 basis point reductions in interest rates is not presented in view of current level of the federal funds rate and other short-term interest rates.

Future net interest income could be affected by the Group's investments in callable securities, prepayment risk related to mortgage loans and mortgage-backed securities, and its structured repurchase agreements and advances from the FHLB. As part of the strategy to limit the interest rate risk and reduce the re-pricing gaps of the Group's assets and liabilities, the maturity and the re-pricing frequency of the liabilities has been extended to longer terms.

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 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 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 exchanged-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. Please refer to Note 8 to the accompanying unaudited consolidated financial statements for further information concerning the Group's derivative activities.

Following is a summary of certain strategies, including derivative activities, currently used by the Group to manage interest rate risk:

Interest rate swaps — The Group entered into forward-settlement swaps to hedge the variability of future interest cash flows of forecasted wholesale borrowings, attributable to changes in the one-month LIBOR rate. Once the forecasted wholesale borrowings transactions occur, the interest rate swap will effectively fix the Group's interest payments on an amount of forecasted interest expense attributable to the one-month LIBOR rate corresponding to the swap notional stated rate. A derivative liability of \$58.3 million was

recognized at September 30, 2012, related to the valuation of these swaps. Refer to Note 8 of the unaudited consolidated financial statements for a description of these swaps.

Swap options — In July 2012, the Group purchased options to enter into interest rate swaps, not designated as cash flow hedges, with an aggregate notional amount of \$200 million. At September 30, 2012, the purchased options used to manage the exposure on the interest rate swaps represented an asset of \$5.4 million in the consolidated statements of financial position.

S&P options — The Group has offered its customers certificates of deposit with an option tied to the performance of the S&P 500 Index. At the end of five years, the depositor receives a minimum return or a specified percentage of the average increase of the month-end value of the S&P 500 Index. The Group uses option agreements with major money center banks and major broker-dealer companies to manage its exposure to changes in that index. Under the terms of the option agreements, the Group receives the average increase in the month-end value of S&P 500 Index in exchange for a fixed premium. The changes in fair value of the options purchased and the options embedded in the certificates of deposit are recorded in earnings.

At September 30, 2012 and December 31, 2011, the fair value of the purchased options used to manage the exposure to the S&P 500 Index on stock-indexed certificates of deposits represented an asset of \$13.1 million and \$9.3 million, respectively, and the options sold to customers embedded in the certificates of deposit represented a liability of \$12.6 million and \$9.4 million, respectively, recorded in deposits.

Wholesale borrowings — The Group uses interest rate swaps to hedge the variability of interest cash flows of certain repurchase agreements and advances from FHLB that are tied to a variable rate index. The interest rate swaps effectively fix the Group's interest payments on these borrowings. As of September 30, 2012, the Group had \$975 billion in interest rate swaps at an average rate of 2.22% designated as cash flow hedges for \$750 million in repurchase agreements and \$225 million in advances from FHLB that reprice or are being rolled over on a monthly basis. As of September 30, 2012, the Group had \$150 million in forward-settle interest rate swaps at an average rate of 2.78% designated as cash flow hedges.

In addition, the Group has outstanding structured repurchase agreements and advances from FHLB in which the counterparty has the right to put back the borrowing to the Group before their stated maturity under certain conditions.

## **Credit Risk**

Credit risk is the possibility of loss arising from a borrower or counterparty in a credit-related contract failing to perform in accordance with its terms. The principal source of credit risk for the Group is its lending activities. In Puerto Rico, the Group's principal market, according to government data, the economic recession moderated in calendar year 2012 and is expected to improve in calendar year 2013. However, economic growth remains a challenge due to the lack of significant employment growth and a housing sector that remains under pressure in spite of progress made by the Puerto Rico government in reducing its fiscal deficit.

The Group manages its credit risk through a comprehensive credit policy which establishes sound underwriting standards by monitoring and evaluating loan portfolio quality, and by the constant assessment of reserves and loan concentrations. The Group also employs proactive collection and loss mitigation practices.

The Group may also encounter risk of default in relation to its securities portfolio. The securities held by the Group are principally agency mortgage-backed securities. Thus, a substantial portion of these instruments are guaranteed by mortgages, a U.S. government-sponsored entity, or the full faith and credit of the U.S. government. At September 30, 2012, the available-for-sale securities portfolio also includes approximately \$29 million in structured credit investments that are considered of a higher credit risk than agency securities.

Management's Executive Credit Committee, composed of the Group's Chief Executive Officer, Chief Credit Risk Officer and other senior executives, has primary responsibility for setting strategies to achieve the Group's credit risk goals and objectives. Those goals and objectives are set forth in the Group's Credit Policy as approved by the Board.

## Liquidity Risk

Liquidity risk is the risk of the Group not being able to generate sufficient cash from either assets or liabilities to meet obligations as they become due without incurring substantial losses. The Board has established a policy to manage this risk. The Group's cash requirements principally consist of deposit withdrawals, contractual loan funding, repayment of borrowings as these mature, and funding of new and existing investments as required.

The Group's business requires continuous access to various funding sources. While the Group is able to fund its operations through deposits as well as through advances from the FHLB of New York and other alternative sources, the Group's business is dependent upon other wholesale funding sources. Although the Group has selectively reduced its use of wholesale funding sources, such as repurchase agreements and brokered deposits, it is still significantly dependent on repurchase agreements. The Group's repurchase agreements have been structured with initial terms that mature in ten years, and for four repurchase agreements totaling \$1.75 billion, the counterparties have the right to exercise at par on a quarterly basis put options before their contractual maturities. The Group's \$500 million repurchase agreement that matures on March 2, 2017 also provides for an optional early termination by either party upon no less than two business days' prior written notice to the other party. In the event of any such optional early termination, the amounts owed by or to the terminating party by the other party on the optional early termination date must take account of the termination value of the transaction, as determined by the calculation agent in the manner described in the repurchase agreement.

Brokered deposits are typically offered through an intermediary to small retail investors. The Group's ability to continue to attract brokered deposits is subject to variability based upon a number of factors, including volume and volatility in the global securities markets, the Group's credit rating, and the relative interest rates that it is prepared to pay for these liabilities. Brokered deposits are generally considered a less stable source of funding than core deposits obtained through retail bank branches. Investors in brokered deposits are generally more sensitive to interest rates and will generally move funds from one depository institution to another based on small differences in interest rates offered on deposits.

Although the Group expects to have continued access to credit from the foregoing sources of funds, there can be no assurance that such financing sources will continue to be available or will be available on favorable terms. In a period of financial disruption or if negative developments occur with respect to the Group, the availability and cost of the Group's funding sources could be adversely affected. In that event, the Group's cost of funds may increase, thereby reducing its net interest income, or the Group may need to dispose of a portion of its investment portfolio, which depending upon market conditions, could result in realizing a loss or experiencing other adverse accounting consequences upon the dispositions. The Group's efforts to monitor and manage liquidity risk may not be successful to deal with dramatic or unanticipated changes in the global securities markets or other reductions in liquidity driven by the Group or market-related events. In the event that such sources of funds are reduced or eliminated and the Group is not able to replace these on a cost-effective basis, the Group may be forced to curtail or cease its loan origination business and treasury activities, which would have a material adverse effect on its operations and financial condition.

As of September 30, 2012, the Group had approximately \$515.5 million in cash and cash equivalents, \$270.0 million in securities purchased under agreements to resell, \$135.8 million in investment securities, \$590.8 million in commercial loans, \$428.5 million in mortgage loans, \$54.6 million in consumer loans, and \$37.4 million in leases available to cover liquidity needs.

## **Operational Risk**

Operational risk is the risk of loss from inadequate or failed internal processes, personnel and systems or from external events. All functions, products and services of the Group are susceptible to operational risk.

The Group faces ongoing and emerging risk and regulatory pressure related to the activities that surround the delivery of banking and financial products. Coupled with external influences such as market conditions, security risks, and legal risk, the potential for operational and reputational loss has increased. In order to mitigate and control operational risk, the Group has developed, and continues to enhance, specific internal controls, policies and procedures that are designed to identify and manage operational risk at appropriate levels throughout the organization. The purpose of these policies and procedures is to provide reasonable assurance that the Group's business operations are functioning within established limits.

The Group classifies operational risk into two major categories: business specific and corporate-wide affecting all business lines. For business specific risks, a risk assessment group works with the various business units to ensure consistency in policies, processes and assessments. With respect to corporate-wide risks, such as information security, business recovery, legal and compliance, the Group has specialized groups, such as Information Security, Enterprise Risk Management, Corporate Compliance, Information Technology and Operations. These groups assist the lines of business in the development and implementation of risk management practices specific to the needs of the business groups. All these matters are reviewed and discussed in the Information Technology Steering Committee, and the Risk Management and Compliance Committee.

The Group is subject to extensive federal and Puerto Rico regulation, and this regulatory scrutiny has been significantly increasing over the last several years. The Group has established and continues to enhance procedures based on legal and regulatory requirements that are reasonably designed to ensure compliance with all applicable statutory and regulatory requirements. The Group has a corporate compliance function headed by a Compliance Director who reports to the Chief Risk Officer and is responsible for the oversight of regulatory compliance and implementation of a company-wide compliance program.

## **Concentration Risk**

Substantially all of the Group's business activities and a significant portion of its credit exposure are concentrated in Puerto Rico. As a consequence, the Group's profitability and financial condition may be adversely affected by an extended economic slowdown, adverse political or economic developments in Puerto Rico or the effects of a natural disaster, all of which could result in a reduction in loan originations, an increase in non-performing assets, an increase in foreclosure losses on mortgage loans, and a reduction in the value of its loans and loan servicing portfolio.



#### **Item 4. CONTROLS AND PROCEDURES**

##### **Disclosure Controls and Procedures**

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out under the supervision and with the participation of the Group's management, including the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Group's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based upon such evaluation, the CEO and the CFO have concluded that, as of the end of such period, the Group's disclosure controls and procedures provided reasonable assurance of effectiveness in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Group in the reports that it files or submits under the Exchange Act. Notwithstanding the foregoing, a control system, no matter how well designed and operated, can provide only reasonable, not absolute assurance that it will detect or uncover failures within the Group to disclose material information otherwise required to be set forth in the Group's periodic reports.

##### **Internal Control over Financial Reporting**

There was no change in the Group's internal control over financial reporting (as such term is defined on rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, the Group's internal control over financial reporting.

## **PART - II OTHER INFORMATION**

### **Item 1. LEGAL PROCEEDINGS**

The Group and its subsidiaries are defendants in a number of legal proceedings incidental to their business. The Group is vigorously contesting such claims. Based upon a review by legal counsel and the development of these matters to date, management is of the opinion that the ultimate aggregate liability, if any, resulting from these claims will not have a material adverse effect on the Group's financial condition or results of operations.

### **Item 1A. RISK FACTORS**

In addition to other information set forth in this report, you should carefully consider the risk factors included in the Group's Annual Report on Form 10-K, as updated by this report and other filings the Group makes with the SEC under the Exchange Act. Additional risks and uncertainties not presently known to us at this time or that the Group currently deems immaterial may also adversely affect the Group's business, financial condition or results of operations.

*A decline in the market value of the Group's investment securities portfolio could adversely impact its regulatory capital ratios.*

The Federal Reserve Board, together with other federal banking regulatory agencies, recently issued proposed capital rules to implement the so-called "Basel III" capital framework in the United States. Among other things, the proposed rules would require banking organizations such as Oriental Bank to include gains and losses on its securities holdings classified as available-for-sale ("AFS") in its common equity tier 1 capital ("CET1"). This aspect of the rules would be phased in over six years with full gain and loss flow-through to capital starting in 2018. Currently, unrealized losses on AFS equity securities are counted against Tier 1 capital, unrealized gains on AFS equity securities are partially included in Tier 2 capital and unrealized gains and losses on AFS debt securities are excluded from regulatory capital. However, these unrealized gains and losses are reflected in stockholders' equity under accounting principles generally accepted in the United States ("GAAP"). The agencies' proposals introduce the concept of CET1—which is comprised of qualifying common stock instruments, retained earnings, accumulated other comprehensive income ("AOCI"), certain qualifying minority interests in consolidated subsidiaries and other adjustments and establish a new minimum ratio of CET1 to total risk-weighted assets of 4.5% and a capital conservation buffer of 2.5% to be phased in over several years. Because of the inclusion of AOCI, unlike the current general risk-based capital rules, unrealized gains and losses on all AFS-classified securities would flow through to CET1 capital, after the transition period, if the proposals are adopted in their current form. The Group's CET1 levels are likely to be significantly more volatile under the agencies' proposals than previously because unrealized gains and losses on AFS classified securities recognized in stockholders' equity on the balance sheet for accounting purposes would also be incorporated for regulatory capital purposes. Accordingly, a decline in the market value of the Group's investment securities portfolio could adversely impact its regulatory capital ratios.

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

The Group's operations are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of its operations. Because its business is highly regulated, the laws, rules and regulations applicable to the Group are subject to regular modification and change. For example, the Dodd-Frank Act has a broad impact on the financial services industry, including significant regulatory and compliance changes, such as: (i) enhanced resolution authority of troubled and failing banks and their holding companies; (ii) enhanced lending limits strengthening the existing limits on a depository institution's credit exposure to one borrower and to affiliates; (iii) increased capital and liquidity requirements; (iv) increased regulatory examination fees; (v) changes to assessments to be paid to the FDIC for federal deposit insurance; (vi) prohibiting bank holding companies, such as the Group, from including in regulatory Tier 1 capital future issuances of trust preferred securities or other hybrid debt and equity securities; (vii) caps on the interchange fees that banks are able to charge merchants for debit card transactions pursuant to the "Durbin Amendment"; and (viii) numerous other provisions designed to improve supervision and oversight of the financial services industry. Additionally, the Dodd-Frank Act established a new framework for systemic risk oversight within the financial system to be distributed among new and existing federal regulatory agencies, including the Financial Stability Oversight Council, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the FDIC. It also creates a new consumer financial protection regulator, the Consumer Financial Protection Bureau ("CFPB"), which assumed most of the consumer financial protection regulatory responsibilities that were exercised by federal banking regulators and other agencies. Further, the Dodd-Frank Act addresses many corporate governance and executive compensation matters that affect most U.S. publicly-traded companies, including the Group.

Certain recent regulatory changes under the Dodd-Frank Act, and otherwise, apply only to depository institutions with more than \$10 billion in total assets, including requirements to undergo regular “stress testing” of capital under hypothetical adverse economic scenarios, “large bank” adjustments to assessments paid to the FDIC for deposit insurance, supervision and examination by the CFPB, and requirements to establish a risk committee on a company’s board of directors. In addition, financial institutions with more than \$10 billion in assets will not be eligible for the “commercial end user” exemption to Dodd-Frank Act’s mandatory clearing requirements for swaps and security-based swaps transactions used to hedge commercial risk. Although the Group expects that it and Oriental Bank will have total assets of less than \$10 billion after the Closing of the proposed BBVAPR Acquisition and the planned deleveraging of the Oriental Bank’s and BBVAPR Bank’s investment securities and wholesale funding portfolios, the Group and Oriental Bank may still be treated for certain regulatory and supervisory purposes as institutions with more than \$10 billion in assets based on the combined total assets of the Oriental Bank and BBVAPR Bank prior to the merger, until such time as the Bank (or the Group, as applicable) has closed four consecutive quarters with \$10 billion or less in total assets. If the Group is not able to complete the deleveraging or otherwise grows to have more than \$10 billion of assets through additional acquisitions or organic growth, the Group’s costs of doing business would be likely to increase permanently as a result of these requirements.

Given that many of the provisions of the Dodd-Frank Act are being implemented over time and are subject to implementing regulations, the full extent of the impact that such requirements, and other legislative and regulatory developments, will have on the Group’s operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of the Group’s business activities, require changes to certain of its business practices, impose upon the Group more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect the Group’s business. In particular, the potential impact of the Dodd-Frank Act on the Group’s operations and activities, both currently and prospectively, include, among others:

- a reduction in the Group’s ability to generate or originate revenue-producing assets as a result of compliance with heightened capital standards;
- increased cost of operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, and higher deposit insurance premiums;
- the limitation on the Group’s ability to raise capital through the use of trust preferred securities as these securities will no longer be included as Tier I capital going forward; and
- the limitation on the Group’s ability to expand consumer product and service offerings due to anticipated stricter consumer protection laws and regulations.

Further, the Group may be required to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements. Failure to comply with the new requirements may negatively impact the Group’s results of operations and financial condition. While the Group cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have, these changes could be materially adverse to the Group results of operations.

***Legislative and other measures that may be taken by Puerto Rico governmental authorities could materially increase the Group’s tax burden or otherwise adversely affect its financial condition, results of operations or cash flows.***

OIB, the Group’s international banking entity pursuant to the International Banking Center Regulatory Act of Puerto Rico (the “IBE Act”), provides the Group with significant tax advantages. OIB is exempt from Puerto Rico income taxes

on interest earned on, or gain realized from the sale of, non-Puerto Rico assets, including U.S. government obligations and certain mortgage-backed securities. This exemption has allowed the Group to have effective tax rates significantly below the maximum statutory tax rates. In the past, the Legislature of Puerto Rico has considered proposals to curb the tax benefits afforded to international banking entities. Recently, a new Puerto Rico law was enacted in this area. Although it did not repeal the IBE Act, the new law does not allow new license applications under the IBE Act to organize and operate an international banking entity. Any newly organized entity (now called an “international financial entity”) must be licensed under the new law and such entity (as opposed to existing international banking entities organized under the IBE Act, including OIB, which are “grandfathered”) will generally be subject to a 4% Puerto Rico income tax rate. In the event other legislation is passed in Puerto Rico to eliminate or modify the tax exemption enjoyed by international banking entities, the consequences could have a materially adverse impact on the Group, including increasing the tax burden or otherwise adversely affecting the Group’s financial condition, results of operations or cash flows.

### **Risks Related to the Proposed BBVAPR Acquisition**

*The BBVAPR Companies are subject to similar business risks that the Group faces.*

The BBVAPR Companies concentrate their business activities in the geographic area, operate their businesses and offer financial products that are similar to the Group’s, and therefore, the BBVAPR Companies are affected by many of the same macroeconomic conditions in Puerto Rico and similar risks faced by the Group in its business operations.

***The Group may not receive the necessary regulatory approvals to consummate the BBVAPR Acquisition.***

The consummation of the proposed BBVAPR Acquisition is subject to the receipt of all necessary regulatory approvals, including those of federal and Puerto Rico bank regulators. In determining whether to approve a proposed acquisition, federal bank regulators will consider, among other factors, the effect of the acquisition on competition, the Group's financial condition and future prospects, and the financial stability of the United States. The regulators also review current and projected capital ratios and levels, the competence, experience, and integrity of management and its record of compliance with laws and regulations, the convenience and needs of the communities to be served (including the acquiring institution's record of compliance under the Community Reinvestment Act of 1977) and the effectiveness of the acquiring institution in combating money laundering activities. Such regulatory approvals may not be granted at all or may be granted only on terms that are so materially burdensome that they would prevent completion of the proposed transaction pursuant to the Acquisition Agreement. The Group may also be required to sell branches as a condition to receiving regulatory approval and be subject to the Group's ability to find third-party purchasers for the divestitures of such branches on satisfactory terms and conditions, which may reduce the benefit of the BBVAPR Acquisition. There can be no assurance as to when or whether these regulatory approvals will be received or the conditions associated with any approval.

***The Group may not be able to realize the anticipated benefits of the BBVAPR Acquisition.***

The Group's future growth and profitability depend, in part, on the ability to successfully manage the combined operations. The success of the Group's proposed BBVAPR Acquisition will depend on, among other things, its ability to assess the quality of assets acquired, to realize anticipated cost savings and to integrate the acquired companies in a manner that permits growth opportunities and does not materially disrupt the Group's or the BBVAPR Companies' existing customer relationships or result in decreased revenues resulting from any loss of customers. If the Group is not able to successfully achieve these objectives, the anticipated benefits of the BBVAPR Acquisition may not be realized fully or at all or may take longer to realize than expected.

***Loans that the Group will acquire in the BBVAPR Acquisition may be subject to greater than anticipated impairment.***

The Group will make fair value estimates of certain assets and liabilities in recording the BBVAPR Acquisition. Actual values of these assets and liabilities could differ from the Group's estimates, which could result in the Group not achieving the anticipated benefits of the BBVAPR Acquisition. In addition, BBVAPR Bank's loan scoring system may be different than the Group's, and as the Group evaluates BBVAPR Bank's loan portfolio using the its systems, the Group may have to make additional adjustments.

Given the economic conditions in Puerto Rico, the Group may continue to experience increased credit costs or need to take greater than anticipated markdowns and make greater than anticipated provisions to increase the allowances for loan losses on the loans acquired that could adversely affect the Group's financial condition and results of operations in the future.

***The Group may not be able to complete the planned deleveraging of Oriental Bank's and BBVAPR Bank's investment securities and wholesale funding portfolios.***

In connection with the BBVAPR Acquisition, the Group intends to complete the sale of approximately \$1.6 billion of its and BBVAPR Bank's investment securities and use the proceeds from such sales as well as approximately \$200 million of cash to repay approximately \$1.8 billion of its and BBVAPR Bank's wholesale funding to further shift the Group's funding base from investment securities and wholesale funding to higher yielding assets, reduce interest rate

sensitivity and improve regulatory capital ratios. The completion of the deleveraging transactions could be delayed or the Group may not be able to complete the deleveraging on satisfactory terms or at all. If the Group is unable to complete the deleveraging in a timely manner, it may be permanently subject to additional regulatory requirements (see “—The Group operates in a highly regulated environment and may be adversely affected by changes in federal and local laws and regulations.”) and may be required to raise additional capital. The Group expects to incur a one-time charge to income before income taxes of approximately \$10 million (or \$7.6 million after giving effect to income taxes) as well as a reduction to pre-tax income of approximately \$6.2 million in 2013 and approximately \$4.0 million in 2014 (or \$4.3 million and \$2.8 million, respectively, after giving effect to income taxes) in connection with the deleveraging; however, the Group could incur larger than expected losses based on market conditions at the time the deleveraging is completed, and those losses could be material.

***The Group may not be able to integrate BBVAPR’s business into its operations.***

The successful integration of BBVAPR’s banking operations and the Group’s future growth and profitability depend in part on the Group’s ability to successfully manage the combined operations. Integration of an acquired business can be complex and costly, sometimes including combining relevant accounting and data processing systems and management controls and policies, as well as managing relevant relationships with employees, clients, suppliers and other business partners. Integration efforts could divert management attention and resources, which could adversely affect its operations or results. The loss of key employees in connection with this acquisition could adversely affect the Group’s ability to successfully conduct the combined operations. In connection with the BBVAPR Acquisition, the BBVAPR Companies have offered bonuses to certain of their executives if they remain with the BBVAPR Companies through the Closing. However, there can be no assurance that any of these executives will choose to continue

working at the combined business following the completion of the BBVAPR Acquisition, or if they do, that the Group will be able to successfully integrate any of these executives as part of its management team in the combined business.

The BBVAPR Acquisition may also result in business disruptions that cause the Group to lose customers or cause customers to move their accounts or business to competing financial institutions. It is possible that the integration process related to the proposed acquisition could disrupt the Group's ongoing business or result in inconsistencies in customer service that could adversely affect the Group's ability to maintain relationships with clients, customers, depositors and employees. The Group's inability to overcome these risks could have a material adverse effect on its business or financial condition, results of operations and future prospects. There is no assurance that the Group's integration efforts will not result in other unanticipated costs.

***The Group may not be able to agree with BBVA on a transition services agreement that will provide the Group with sufficient services to facilitate the integration of the BBVAPR Acquisition.***

At Closing, BBVA and the Group will enter into a transition services agreement pursuant to which BBVA will provide the Group with certain services to assist with the day-to-day operations of the acquired companies and their transition to the Group's infrastructure, and to provide data for the integration of information, for a period of up to 12 months. There can be no assurance that the services that BBVA agrees to provide to the Group will be sufficient, in scope or duration, to ensure the successful integration of the BBVAPR Companies.

***If the BBVAPR Acquisition is completed, we will incur significant transaction and acquisition-related costs.***

If the BBVAPR Acquisition is completed, the Group expects to incur certain one-time restructuring charges of approximately \$40 million in connection with the transaction. The substantial majority of non-recurring expenses resulting from the BBVAPR Acquisition will be comprised of transaction costs related to the BBVAPR Acquisition and financing arrangements and employment-related costs. The Group also will incur transaction fees and costs related to formulating and implementing integration plans. The Group continues to assess the magnitude of these costs, and additional unanticipated costs may be incurred in the business integration of the two groups of companies. Although the Group expects that the elimination of duplicative costs, as well as the realization of other efficiencies or synergies related to the integration of the businesses should allow the Group to offset incremental transaction and acquisition-related costs over time, this net benefit may not be achieved in the near term, or at all.

***The Group may fail to consummate the BBVAPR Acquisition, which may subject it to penalties.***

While the Group intends and expects to meet all of the conditions required to consummate the BBVAPR Acquisition, the Group's ability to consummate the BBVAPR Acquisition is subject to certain events that are beyond its control. These events include the receipt of regulatory approvals from the FDIC, the Federal Reserve Board, FINRA and the OCFI (the "Approvals"). On October 10, 2012, the OCFI approved Oriental's acquisition of BBVAPR Bank and the merger of BBVAPR Bank with and into Oriental Bank, with Oriental Bank as the surviving entity. See "—The Group may not receive the necessary regulatory approvals to consummate the BBVAPR Acquisition." for factors that the federal bank regulators may consider in granting the Approvals.

Under the Acquisition Agreement, the Group may be subject to a termination fee of \$25 million if the Closing does not occur before one year after execution of the Acquisition Agreement (or before 15 months after execution of the Acquisition Agreement in certain circumstances), the Acquisition Agreement is terminated, and the failure to close within one year (or such later date) is due to the Group's inability to raise the specified additional funds or to obtain the Approvals or any other reason other than certain breaches by BBVA, subject to certain conditions. In addition, BBVA could seek damages in excess of \$25 million if BBVA terminates the Acquisition Agreement due to the Group's failure



to satisfy the funding requirement or if the Group's willful and knowing breach of the Acquisition Agreement is the proximate cause of the Closing not having been consummated, and BBVA suffers losses as a result in excess of the \$25 million termination fee. If BBVA decides to terminate the Acquisition Agreement and collect the termination fee, such additional damages would be limited to BBVA's losses in excess of the termination fee, and could not exceed an additional \$25 million. Such limit would not apply if BBVA does not elect to terminate the Acquisition Agreement and collect the termination fee.

## **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Information as to the sale of the Convertible Preferred Stock was furnished in the Group's Current Report on Form 8-K filed with the SEC on July 3, 2012. The shares of Convertible Preferred Stock were purchased by "qualified institutional buyers" as defined in Rule 144A under the Securities Act of 1933, as amended.

## **Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

**Exhibit No.**

**Description of Document:**

- 2.1 Acquisition Agreement, dated June 28, 2012, between the Group and Banco Bilbao Vizcaya Argentaria, S.A., relating to the purchase and sale of 100% of the common stock of each of BBVA PR Holding Corporation and BBVA Securities of Puerto Rico, Inc. (1)
- 3.1 Certificate of Designations of 7.125% Non-Cumulative Perpetual Preferred Stock, Series D. (2)
- 3.2 Certificate of Designations of 8.750% Non-Cumulative Convertible Perpetual Preferred Stock, Series C. (3)
- 4.1 Form of Certificate for the 8.750% Non-Cumulative Convertible Perpetual Preferred Stock, Series C. (4)
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 The following materials from Oriental Financial Group Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Unaudited Consolidated Statements of Financial Condition, (ii) Unaudited Consolidated Statements of Operations, (iii) Unaudited Consolidated Statements of Comprehensive Income, (iv) Unaudited Consolidated Statements of Changes in Stockholders' Equity, (v) Unaudited Consolidated Statements of Cash Flows, and (vi) Notes to Unaudited Consolidated Financial Statements.

(1) Incorporated herein by reference to Exhibit 2.1 of the Group's Current Report on Form 8-K filed with the SEC on July 3, 2012.

(2) Incorporated herein by reference to Exhibit 3.1 of the Group's Current Report on Form 8-K filed with the SEC on November 8, 2012.

(3) Incorporated herein by reference to Exhibit 3.2 of the Group's Current Report on Form 8-K filed with the SEC on July 3, 2012.

(4) Incorporated herein by reference to Exhibit 4.1 of the Group's Current Report on Form 8-K filed with the SEC on July 3, 2012.



**Signatures**

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

**ORIENTAL FINANCIAL GROUP INC.**

**(Registrant)**

By: /s/ José Rafael Fernández

Date: November 9, 2012

José Rafael Fernández  
President and Chief Executive Officer

By: /s/ Ganesh Kumar

Date: November 9, 2012

Ganesh Kumar  
Executive Vice President and Chief Financial  
Officer

