OFG BANCORP
Form 10-Q
August 09, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

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

OFG Bancorp

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

Principal Executive Offices:

254 Muñoz Rivera Avenue

San Juan, Puerto Rico 00918

Telephone Number: (787) 771-6800

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large Accelerated Filer ¨   Accelerated Filer x   Non-Accelerated Filer ¨   Smaller Reporting Company ¨
(Do not check if a smaller reporting company)

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

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

45,640,105 common shares ($1.00 par value per share) outstanding as of July 31, 2013

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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 OFG Bancorp, formerly known as Oriental Financial Group Inc. ("we," "our," "us" or the "Company"), 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 Company'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 a "will," "would," "should," "could," "might," "can," "may," or similar expressions are generally intended to identify forward-lo 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 Company'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 Company'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; and

- difficulties in integrating the acquired Puerto Rico operations of Banco Bilbao Vizcaya Argentaria, S. A. (“BBVAPR”) into the Company’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 Company’s ability to grow its core businesses; decisions to downsize, sell or close units or otherwise change the Company’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 Company as of the date of this report, and other than as required by law, including the requirements of applicable securities laws, the Company 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.

Item 1. Financial Statements

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

AS OF JUNE 30, 2013 AND DECEMBER 31, 2012

	June 30, 2013	December 31, 2012
	(In thousands, except share data)	
ASSETS		
Cash and cash equivalents		
Cash and due from banks	$ 737,330	$ 855,490
Money market investments	10,983	13,205
Total cash and cash equivalents	**748,313**	**868,695**
Securities purchased under agreements to resell	**-**	**80,000**
Investments:		
Trading securities, at fair value, with amortized cost of $2,286 (December 31, 2012 - $508)	2,209	495
Investment securities available-for-sale, at fair value, with amortized cost of $1,807,335 (December 31, 2012 - $2,118,825)	1,836,229	2,194,286
Federal Home Loan Bank (FHLB) stock, at cost	22,156	38,411
Other investments	66	73
Total investments	**1,860,660**	**2,233,265**
Securities sold but not yet delivered	**16,732**	**-**
Loans:		
Mortgage loans held-for-sale, at lower of cost or fair value	78,350	64,145
Loans not covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of $46,625 (December 31, 2012 - $39,921)	4,543,299	4,709,778
Loans covered under shared-loss agreements with the FDIC, net of allowance for loan and lease losses of $53,992 (December 31, 2012 - $54,124)	369,380	395,307
Total loans, net	**4,991,029**	**5,169,230**
Other assets:		
FDIC shared-loss indemnification asset	236,472	286,799
Foreclosed real estate covered under shared-loss agreements with the FDIC	25,193	22,283
Foreclosed real estate not covered under shared-loss agreements with the FDIC	56,496	51,233
Accrued interest receivable	17,508	17,554
Deferred tax asset, net	155,165	122,501
Premises and equipment, net	84,301	84,997
Customers' liability on acceptances	30,571	26,996
Servicing assets	12,994	10,795
Derivative assets	19,655	21,889
Goodwill	76,383	76,383

Other assets		104,462		123,642
Total assets	$	**8,435,934**	$	**9,196,262**
LIABILITIES AND STOCKHOLDERS' EQUITY				
Deposits:				
Demand deposits	$	2,294,635	$	2,447,152
Savings accounts		1,006,558		634,819
Certificates of deposit		2,363,845		2,607,588
Total deposits		**5,665,038**		**5,689,559**
Borrowings:				
Short term borrowings		-		92,210
Securities sold under agreements to repurchase		1,313,870		1,695,247
Advances from FHLB and other borrowings		322,300		554,177
Subordinated capital notes		98,961		146,038
Total borrowings		**1,735,131**		**2,487,672**
Other liabilities:				
Derivative liabilities		16,701		26,260
Acceptances executed and outstanding		30,571		26,996
Accrued expenses and other liabilities		117,569		102,169
Total liabilities		**7,565,010**		**8,332,656**
Commitments and contingencies (See Notes 14 and 15)				
Stockholders' equity:				
Preferred stock; 10,000,000 shares authorized; 1,340,000 shares of Series A, 1,380,000 shares of Series B, and 960,000 shares of Series D issued and outstanding, (December 31, 2012 - 1,340,000; 1,380,000; and 960,000) $25 liquidation value		92,000		92,000
84,000 shares of Series C issued and outstanding (December 31, 2012 - 84,000); $1,000 liquidation value		84,000		84,000
Common stock, $1 par value; 100,000,000 shares authorized; 52,688,584 shares issued; 45,640,105 shares outstanding (December 31, 2012 - 52,670,878; 45,580,281)		52,689		52,671
Additional paid-in capital		538,105		537,453
Legal surplus		57,906		52,143
Retained earnings		111,292		70,734
Treasury stock, at cost, 7,048,479 shares (December 31, 2012 - 7,090,597 shares)		(80,834)		(81,275)
Accumulated other comprehensive income, net of tax of -$174 (December 31, 2012 - $1,802)		15,766		55,880
Total stockholders' equity		**870,924**		**863,606**
Total liabilities and stockholders' equity	$	**8,435,934**	$	**9,196,262**

See notes to unaudited consolidated financial statements.

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OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2013 AND 2012

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands, except per share data)			
Interest income:				
Loans not covered under shared-loss agreements with the FDIC	$ 90,611	$ 17,223	$ 170,874	$ 35,345
Loans covered under shared-loss agreements with the FDIC	23,999	20,342	44,228	41,884
Total interest income from loans	**114,610**	**37,565**	**215,102**	**77,229**
Mortgage-backed securities	9,080	21,573	19,898	49,636
Investment securities and other	2,118	1,650	4,436	3,843
Total interest income	**125,808**	**60,788**	**239,436**	**130,708**
Interest expense:				
Deposits	9,973	7,885	20,451	17,008
Securities sold under agreements to repurchase	7,109	16,500	14,357	34,070
Advances from FHLB and other borrowings	2,187	2,926	3,847	5,930
FDIC-guaranteed term notes	-	-	-	909
Subordinated capital notes	1,170	321	2,830	649
Total interest expense	**20,439**	**27,632**	**41,485**	**58,566**
Net interest income	**105,369**	**33,156**	**197,951**	**72,142**
Provision for non-covered loan and lease losses	37,527	3,800	45,443	6,800
Provision for covered loan and lease losses, net	1,211	1,467	1,883	8,624
Total provision for loan and lease losses	**38,738**	**5,267**	**47,326**	**15,424**
Net interest income after provision for loan and lease losses	**66,631**	**27,889**	**150,625**	**56,718**
Non-interest income:				
Financial service revenue	8,030	5,903	15,690	11,791
Banking service revenue	13,334	3,145	25,716	6,225
Mortgage banking activities	2,525	2,436	5,679	4,938
Total banking and financial service revenues	**23,889**	**11,484**	**47,085**	**22,954**
FDIC shared-loss expense, net	(19,965)	(5,583)	(32,836)	(10,410)
Net gain (loss) on:				
Sale of securities	-	11,979	-	19,338
Derivatives	1,569	(107)	1,271	(108)
Early extinguishment of subordinated capital notes	-	-	1,061	-

Other	2,303	63	2,349	(779)
Total non-interest income, net	**7,796**	**17,836**	**18,930**	**30,995**
Non-interest expense:				
Compensation and employee benefits	24,089	11,184	47,338	21,550
Professional and service fees	7,710	5,222	16,832	10,643
Occupancy and equipment	8,066	4,292	17,282	8,501
Insurance	2,723	1,442	5,401	3,262
Electronic banking charges	4,094	1,609	7,822	3,166
Advertising, business promotion, and strategic initiatives	1,670	1,564	3,079	2,412
Merger and restructuring charges	5,274	-	10,808	-
Foreclosure, repossession and other real estate expenses	2,156	936	3,661	1,686
Loan servicing and clearing expenses	1,884	955	3,360	1,923
Taxes, other than payroll and income taxes	5,132	(107)	7,754	1,067
Loss on sale of foreclosed real estate and other repossessed assets	1,696	886	3,573	1,282
Communication	835	392	1,699	781
Printing, postage, stationary and supplies	851	322	2,017	630
Director and investor relations	377	342	613	651
Other	2,265	671	4,393	1,555
Total non-interest expense	**68,822**	**29,710**	**135,632**	**59,109**
Income before income taxes	**5,605**	**16,015**	**33,923**	**28,604**
Income tax expense (benefit)	(31,934)	1,057	(24,808)	2,994
Net income	**37,539**	**14,958**	**58,731**	**25,610**
Less: dividends on preferred stock	(3,466)	(1,201)	(6,931)	(2,401)
Income available to common shareholders	**$ 34,073**	**$ 13,757**	**$ 51,800**	**$ 23,209**
Earnings per common share:				
Basic	**$ 0.75**	**$ 0.34**	$ **1.14**	**$ 0.57**
Diluted	**$ 0.68**	**$ 0.34**	$ **1.05**	**$ 0.57**
Average common shares outstanding and equivalents	**52,968**	**40,808**	**52,929**	**40,986**
Cash dividends per share of common stock	**$ 0.06**	**$ 0.06**	$ **0.12**	**$ 0.12**

See notes to unaudited consolidated financial statements.

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE QUARTERS AND SIX-MONTHS PERIODS ENDED JUNE 30, 2013 AND 2012

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
Net income	**$ 37,539**	**$ 14,958**	**$ 58,731**	**$ 25,610**
Other comprehensive loss before tax:				
Unrealized (gain) loss on securities available-for-sale	(35,576)	7,059	(46,568)	9,000
Realized gain on investment securities included in net income	-	(11,979)	-	(19,338)
Unrealized loss (gain) on cash flow hedges	3,016	(6,791)	4,477	(8,792)
Other comprehensive loss before taxes	**(32,560)**	**(11,711)**	**(42,091)**	**(19,130)**
Income tax effect	1,275	2,875	1,977	3,260
Other comprehensive loss after taxes	**(31,285)**	**(8,836)**	**(40,114)**	**(15,870)**
Comprehensive income	**$ 6,254**	**$ 6,122**	**$ 18,617**	**$ 9,740**

See notes to unaudited consolidated financial statements.

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2013 AND 2012

	Six-Month Period Ended June 30, 2013	2012
	(In thousands)	
Preferred stock:		
Balance at beginning and end of period	**$ 176,000**	**$ 68,000**
Common stock:		
Balance at beginning of year	52,671	47,809
Exercised stock options	18	33
Balance at end of period	**52,689**	**47,842**
Additional paid-in capital:		
Balance at beginning of year	537,453	499,096
Stock-based compensation expense	888	787
Exercised stock options	167	361
Lapsed restricted stock units	(364)	(392)
Common stock issuance costs	(16)	-
Preferred stock issuance costs	(23)	-
Balance at end of period	**538,105**	**499,852**
Legal surplus:		
Balance at beginning of year	52,143	50,178
Transfer from retained earnings	5,763	2,490
Balance at end of period	**57,906**	**52,668**
Retained earnings:		
Balance at beginning of year	70,734	68,149
Net income	58,731	25,610
Cash dividends declared on common stock	(5,479)	(4,886)
Cash dividends declared on preferred stock	(6,931)	(2,401)
Transfer to legal surplus	(5,763)	(2,490)
Balance at end of period	**111,292**	**83,982**
Treasury stock:		
Balance at beginning of year	(81,275)	(74,808)
Stock repurchased	-	(7,022)
Lapsed restricted stock units	364	392
Stock used to match defined contribution plan	77	35
Balance at end of period	**(80,834)**	**(81,403)**
Accumulated other comprehensive income, net of tax:		
Balance at beginning of year	55,880	37,131
Other comprehensive loss, net of tax	(40,114)	(15,870)
Balance at end of period	**15,766**	**21,261**
Total stockholders' equity	**$ 870,924**	**$ 692,202**

See notes to unaudited consolidated financial statements.

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2013 AND 2012

	Six-Month Period Ended June 30,	
	2013	2012
	(In thousands)	
Cash flows from operating activities:		
Net income	$ **58,731**	$ **25,610**
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred loan origination fees, net of costs	486	297
Amortization of fair value discounts on acquired loans	3,504	-
Amortization of investment securities premiums, net of accretion of discounts	12,624	25,558
Amortization of core deposit and customer relationship intangibles	1,288	75
Amortization of fair value premiums on acquired deposits	9,649	-
FDIC shared-loss expense, net	32,836	10,410
Amortization of prepaid FDIC assessment	-	2,613
Other impairments on securities	7	-
Depreciation and amortization of premises and equipment	5,265	2,373
Deferred income taxes, net	(30,776)	(420)
Provision for covered and non-covered loan and lease losses, net	47,326	15,424
Stock-based compensation	888	787
(Gain) loss on:		
Sale of securities	-	(19,338)
Sale of mortgage loans held for sale	(1,771)	(2,898)
Derivatives	(1,271)	108
Early extinguishment of subordinated capital notes	(1,061)	-
Foreclosed real estate	3,109	1,284
Sale of other repossessed assets	464	-
Sale of premises and equipment	-	(86)
Originations of loans held-for-sale	(179,127)	(93,940)
Proceeds from sale of loans held-for-sale	68,809	49,388
Net (increase) decrease in:		
Trading securities	(1,714)	(34)
Accrued interest receivable	46	2,924
Servicing assets	(2,199)	(322)
Other assets	20,730	4,259
Net increase (decrease) in:		
Accrued interest on deposits and borrowings	(995)	(4,498)
Accrued expenses and other liabilities	12,093	(13,167)
Net cash provided by operating activities	**58,941**	**6,407**
Cash flows from investing activities:		
Purchases of:		

Investment securities available-for-sale	(17,802)	(558,201)
Investment securities held-to-maturity	-	(119,025)
FHLB stock	(12,465)	-
Maturities and redemptions of:		
Investment securities available-for-sale	313,866	378,144
Investment securities held-to-maturity	-	102,251
FHLB stock	28,720	911
Proceeds from sales of:		
Investment securities available-for-sale	75,660	553,602
Foreclosed real estate	18,219	4,639
Other repossessed assets	12,912	1,941
Premises and equipment	1,667	368
Origination and purchase of loans, excluding loans held-for-sale	(422,590)	(112,974)
Principal repayment of loans, including covered loans	528,274	128,340
Reimbursements from the FDIC on shared-loss agreements	18,696	39,729
Additions to premises and equipment	(6,237)	(1,225)
Net change in securities purchased under agreements to resell	80,000	(225,000)
Net cash provided by investing activities	**618,920**	**193,500**

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)

FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2013 AND 2012

	Six-Month Period Ended June 30,			
	2013		2012	
	(In thousands)			
Cash flows from financing activities:				
Net increase (decrease) in:				
Deposits		(36,125)		(212,846)
Short term borrowings		(92,210)		-
Securities sold under agreements to repurchase		(381,358)		-
FHLB advances		(231,617)		5,070
Subordinated capital notes		(46,017)		-
FDIC-guaranteed term notes		-		(105,000)
Exercise of stock options		185		394
Issuance of common stock costs		(16)		-
Issuance of preferred stock costs		(23)		-
Purchase of treasury stock		-		(7,022)
Termination of derivative instruments		1,348		(124)
Dividends paid on preferred stock		(6,931)		(2,401)
Dividends paid on common stock		(5,479)		(4,886)
Net cash used in financing activities		**(798,243)**		**(326,815)**
Net change in cash and cash equivalents		**(120,382)**		**(126,908)**
Cash and cash equivalents at beginning of period		868,695		591,487
Cash and cash equivalents at end of period	**$**	**748,313**	**$**	**464,579**
Supplemental Cash Flow Disclosure and Schedule of Non-cash Activities:				
Interest paid	$	40,491	$	63,266
Income taxes paid	$	378	$	8,031
Mortgage loans securitized into mortgage-backed securities	$	89,590	$	37,730
Transfer from loans to foreclosed real estate and other repossessed assets	$	45,714	$	11,723
Securities sold but not yet delivered	$	16,732	$	-
Reclassification of loans held for investment portfolio to held for sale portfolio	$	40,328	$	5,182

See notes to unaudited consolidated financial statements

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – ORGANIZATION, CONSOLIDATION AND BASIS OF PRESENTATION

Nature of Operations

OFG Bancorp (the "Company") is a publicly-owned financial holding company incorporated under the laws of the Commonwealth of Puerto Rico. The Company operates through various subsidiaries including, a commercial bank, Oriental Bank (or the "Bank"), two broker-dealers, Oriental Financial Services Corp. ("Oriental Financial Services") and OFS Securities, Inc. ("OFS Securities"), an insurance agency, Oriental Insurance, Inc. ("Oriental Insurance") and a retirement plan administrator, Caribbean Pension Consultants, Inc. ("CPC"). The Company also has a special purpose entity, Oriental Financial (PR) Statutory Trust II (the "Statutory Trust II"). Through these subsidiaries and their respective divisions, the Company provides a wide range of banking and financial services such as commercial, consumer and mortgage lending, leasing, auto loans, financial planning, insurance sales, money management and investment banking and brokerage services, as well as corporate and individual trust services. On April 25, 2013, the Company changed its corporate name from Oriental Financial Group Inc. to OFG Bancorp.

On December 18, 2012, the Company purchased from Banco Bilbao Vizcaya Argentaria, S. A. ("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"), an insurance agency, and (ii) BBVA Securities of Puerto Rico, Inc. ("BBVA Securities," now known as "OFS 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" or "BBVAPR."

Basis of Presentation and Use of Estimates

The accounting and reporting policies of the Company 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") for interim financial information and should be read in conjunction with the audited consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2012 ("2012 Form 10-K"). 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 preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the unaudited consolidated financial statements and related disclosures. These estimates are based on information available as of the date of the consolidated financial statements. While management makes its best judgment, actual amounts or results could differ from these estimates. Interim period results are not necessarily indicative of the results to be expected for the full year.

Certain reclassifications have been made to 2012 unaudited consolidated financial statements and notes to the financial statements to conform to the 2013 presentation.

Significant Accounting Policies

We provide a summary of our significant accounting policies in our 2012 Form 10-K under "Notes to Consolidated Financial Statements—Note 1—Summary of Significant Accounting Policies." Below we describe recent accounting changes.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income - In February 2013, the FASB issued an amendment to enhance current disclosure requirements of reclassifications out of accumulated other comprehensive income and their corresponding effect on net income to be presented, in one place, information about significant amounts reclassified and, in some cases, cross-reference to related footnote disclosures. Previously, this information was presented in different places throughout the financial statements. The amendments require disclosure of information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, they require the presentation, either on the face of the statement where net income is presented or in the notes, of significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, the Company is required to cross-reference to other disclosures required under GAAP that provide additional detail about those amounts. The amended guidance was effective for annual and interim reporting periods beginning on or after December 15, 2012, prospectively. Our adoption of the guidance is presented in "Note 13 – Stockholders' Equity and Earnings per Share."

Testing Indefinite-Lived Intangible Assets for Impairment - In July 2012, the FASB issued ASU No. 2012-02, *Intangibles—*

Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment. The ASU is intended to simplify the guidance for testing the decline in the realizable value (impairment) of indefinite-lived intangible assets other than goodwill. Some examples of intangible assets subject to the guidance include indefinite-lived trademarks, licenses and distribution rights. The ASU allows companies to perform a qualitative assessment about the likelihood of impairment of an indefinite-lived intangible asset to determine whether further impairment testing is necessary, similar in approach to the goodwill impairment test. The ASU became effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Our adoption of the guidance had no effect on our unaudited consolidated financial statements.

Offsetting Financial Assets and Liabilities - In December 2011, the FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. The ASU is intended to enhance current disclosure requirements on offsetting financial assets and liabilities. The new disclosures enable financial statement users to compare balance sheets prepared under GAAP and IFRS, which are subject to different offsetting models. The guidance requires disclosure of both gross and net information about instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. The disclosures are required irrespective of whether such instruments are presented gross or net on the balance sheet. In January 2013, the FASB issued ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, which clarify that the scope of this guidance applies to derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amended guidance was effective for annual and interim reporting periods beginning on or after January 1, 2013, with comparative retrospective disclosures required for all periods presented. We adopted the guidance in the first quarter of 2013. Our adoption of the guidance had no effect on our financial condition, results of operations or liquidity since it only impacts disclosures only. The new disclosures required by the amended guidance are included in “Note 17 – Offsetting Arrangements” hereto.

Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution— FASB ASU 2012-06, “Business Combinations” (Topic 805) was issued in October 2012. This update addresses the diversity in practice about how to interpret the terms “on the same basis” and “contractual limitations” when subsequently measuring an indemnification asset recognized in a government-assisted (Federal Deposit Insurance Corporation) acquisition of a financial institution that includes a loss-sharing agreement (indemnification agreement). When a reporting entity recognizes an indemnification asset as a result of a government-assisted acquisition of a financial institution and subsequently the cash flows expected to be collected on the indemnification asset change as a result of a change in cash flows expected to be collected on the assets subject to indemnification, the reporting entity should subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value should be limited to the contractual term of the indemnification agreement, that is, the lesser of the term of the indemnification agreement and the remaining life of the indemnified assets. The amendments in this update are effective for fiscal years and interim periods within those years, beginning on or after December 15, 2012. The adoption of this guidance did not have a material effect on the unaudited consolidated financial statements, since the Company already followed the same basis approach.

Future Application of Accounting Standards

Accounting for Financial Instruments—Credit Losses - In December 2012, the FASB issued a proposed ASU, *Financial Instruments—Credit Losses.* This proposed ASU, or exposure draft, was issued for public comment in order to allow stakeholders the opportunity to review the proposal and provide comments to the FASB, and does not constitute accounting guidance until a final ASU is issued. The exposure draft contains proposed guidance developed by the FASB with the goal of improving financial reporting about expected credit losses on loans, securities and other financial assets held by banks, financial institutions, and other public and private organizations. The exposure draft proposes a new accounting model intended to require earlier recognition of credit losses, while also providing additional transparency about credit risk. The FASB's proposed model would utilize a single "expected credit loss" measurement objective for the recognition of credit losses, replacing the multiple existing impairment models in GAAP which generally require that a loss be "incurred" before it is recognized. The FASB's proposed model represents a significant departure from existing GAAP, and may result in material changes to the Company's accounting for financial instruments. The impact of the FASB's final ASU to the Company's financial statements will be assessed when it is issued. The exposure draft does not contain a proposed effective date. This would be included in the final ASU, when issued.

Other Potential Amendments to Current Accounting Standards - The FASB and International Accounting Standards Board, either jointly or separately, are currently working on several major projects, including amendments to existing accounting standards governing financial instruments, leases, and consolidation and investment companies. As part of the joint financial instruments project, the FASB has issued a proposed ASU that would result in significant changes to the guidance for recognition and measurement of financial instruments, in addition to the proposed ASU that would change the accounting for credit losses on financial instruments discussed above. The FASB is also working on a joint project that would require substantially all leases to be capitalized on the balance sheet. Additionally, the FASB has issued a proposal on principal-agent considerations that would change the way the Company needs to evaluate whether to consolidate Variable Interest Entities ("VIE") and non-VIE partnerships. Furthermore, the FASB has issued a proposed ASU that would change the criteria used to determine whether an entity is subject to the accounting and reporting requirements of an investment company. The principal-agent consolidation proposal would require all VIEs, including those that are investment companies, to be evaluated for consolidation under the same requirements. All of these projects may have significant impacts for the Company. Upon completion of the standards, the Company will need to reevaluate its accounting and disclosures. However, due to ongoing deliberations of the standard setters, the Company is currently unable to determine the effect of future amendments or proposals.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 2 – BUSINESS COMBINATIONS

BBVAPR Acquisition

On December 18, 2012, the Company purchased from BBVA, all of the outstanding common stock of each of BBVAPR Holding and BBVA Securities for an aggregate purchase price of $500 million. Immediately following the closing of the BBVAPR Acquisition, the Company merged BBVAPR Bank with and into Oriental Bank, with Oriental Bank continuing as the surviving entity.

The assets acquired and liabilities assumed as of December 18, 2012 were presented at their fair value. In many cases, the determination of these fair values required management to make estimates about discount rates, expected cash flows, market conditions and other future events that are highly subjective in nature and subject to change. The fair values initially assigned to the assets acquired and liabilities assumed were preliminary and subject to refinement for up to one year after the closing date of the acquisition as new information relative to closing date fair values became available. During the quarter ended June 30, 2013, the Company recorded retrospective adjustments to the preliminary estimated fair values of certain acquired loans, foreclosed real estate, deferred income taxes, and other assets acquired, to reflect new information obtained during the measurement period (as defined by ASC Topic 805), about facts and circumstances that existed as of the acquisition date that, if known, would have affected the acquisition-date fair value measurements. As detailed in the table below, the main adjustment occurred in the loans acquired. The adjustment resulted from in-depth reviews of the actual terms and amortization schedules. The original cash flows were revised to reflect the results of this review.

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

	Book Value December 18, 2012	Fair Value Adjustments, net	Fair Value December 18, 2012	Measurement Period Adjustments, net June 30, 2013	Fair Value as Remeasured June 30, 2013
			(In thousands)		
Assets					
Cash and cash equivalents	$ 394,638	$ -	$ 394,638	$ -	$ 394,638
Investments	561,623	-	561,623	-	561,623
Loans	3,678,979	(118,913)	3,560,066	(12,798)	3,547,268
Accrued interest receivable	19,133	(18,252)	881	-	881
Foreclosed real estate	44,853	(8,896)	35,957	(1,932)	34,025
Deferred tax asset, net	35,327	50,005	85,332	5,300	90,632
Premises and equipment	37,412	29,067	66,479	-	66,479
Legacy goodwill	116,353	(116,353)	-	-	-

Core deposit intangible		-		8,473		8,473		-		8,473
Customer relationship intangible		-		5,060		5,060		-		5,060
Other assets		119,286		(7,663)		111,623		(2,936)		108,687
Total assets acquired		**5,007,604**		**(177,472)**		**4,830,132**		**(12,366)**		**4,817,766**
Liabilities										
Deposits		3,472,951		21,489		3,494,440		-		3,494,440
Securities sold under agreements to repurchase		338,020		20,465		358,485		-		358,485
Other borrowings		348,624		1,108		349,732		-		349,732
Subordinated capital notes		117,000		(7,159)		109,841		-		109,841
Accrued expenses and other liabilities		80,392		(1,438)		78,954		-		78,954
Total liabilities assumed		**4,356,987**		**34,465**		**4,391,452**		**-**		**4,391,452**
Net assets acquired	**$**	**650,617**	**$**	**(211,937)**	**$**	**438,680**	**$**	**(12,366)**	**$**	**426,314**
Cash consideration	**$**	**500,000**	**$**	**-**	**$**	**500,000**	**$**	**-**	**$**	**500,000**
Goodwill					**$**	**61,320**	**$**	**12,366**	**$**	**73,686**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Merger and Restructuring Charges

Merger and restructuring charges are recorded in the unaudited consolidated statement of operations and include incremental costs to integrate the operations of the Company and BBVAPR. These charges represent costs associated with these one-time activities and do not represent ongoing costs of the fully integrated combined organization.

The following table presents severance and employee-related charges, systems integrations and other merger-related charges in connection with the BBVAPR Acquisition for the quarter and six-month period ended June 30, 2013:

	Quarter Ended June 30, 2013 (In thousands)	Six-Month Period Ended June 30, 2013 (In thousands)
Severance and employee-related charges	$ 400	$ 1,150
Systems integrations and related charges	2,231	3,177
Other-contract cancellation fee	2,643	6,481
Total merger and restructuring charges	**$ 5,274**	**$ 10,808**

Restructuring Reserve

Restructuring reserves are established by a charge to merger and restructuring charges, and the restructuring charges are included in the merger and restructuring charges table.

The following table presents the changes in restructuring reserves for the quarter and six-month period ended June 30, 2013:

	Quarter Ended June 30, 2013 (In thousands)	Six-Month Period Ended June 30, 2013 (In thousands)
Balance at the beginning of the period	$ 6,336	$ 4,202
Merger and restructuring charges	5,274	10,808
Cash payments and other	(11,334)	(14,734)
Balance at the end of the period	**$ 276**	**$ 276**

Payments under merger and restructuring reserves associated with the BBVAPR Acquisition are expected to continue in 2013 and will be accounted under applicable accounting guidance to the cost being incurred.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The 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. These assets acquired and liabilities assumed were recorded at fair value on the date of acquisition. 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 indemnification asset represents the portion of estimated losses covered by the shared-loss agreements between the Bank and the FDIC.

The Bank 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 $16.9 million and $15.5 million, net of discount, as of June 30, 2013 and December 31, 2012, respectively. This estimated liability is accounted for as a reduction of the indemnification asset.

The FDIC shared-loss indemnification asset activity for the six-month periods ended June 30, 2013 and 2012 follows:

	Six-Month Period Ended June 30,			
	2013		2012	
	(In thousands)			
Balance at beginning of period	$	286,799	$	392,367
Shared-loss agreements reimbursements from the FDIC		(18,696)		(39,729)
Increase (decrease) in expected credit losses to be covered under shared-loss agreements, net		(2,015)		12,748
FDIC shared-loss expense, net		(32,836)		(10,410)
Incurred expenses to be reimbursed under shared-loss agreements		3,220		4,791
Balance at end of period	**$**	**236,472**	**$**	**359,767**

During the quarter ended June 30, 2013, the Company recorded $7.1 million in additional amortization of the FDIC indemnification asset from stepped up costs recoveries on certain construction and leasing pools.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 3 – SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL AND INVESTMENTS

Money Market Investments

The Company considers as cash equivalents all money market instruments that are not pledged and that have maturities of three months or less at the date of acquisition. At June 30, 2013 and December 31, 2012, money market instruments included as part of cash and cash equivalents amounted to $11.0 million and $13.2 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 December 31, 2012, securities purchased under agreements to resell amounted to $80.0 million. The fair value of the collateral securities held by the Company on these transactions as of December 31, 2012 was approximately $82.1 million. On June 30, 2013 the Company had no securities purchased under agreements to resell.

Investment Securities

The amortized cost, gross unrealized gains and losses, fair value, and weighted average yield of the securities owned by the Company at June 30, 2013 and December 31, 2012 were as follows:

	June 30, 2013				
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**	**Weighted Average Yield**
			(In thousands)		
Available-for-sale					
Mortgage-backed securities					
FNMA and FHLMC certificates	$ 1,358,834	$ 36,112	$ 4,324	$ 1,390,622	2.92%
GNMA certificates	10,590	604	13	11,180	4.88%
CMOs issued by US Government sponsored agencies	250,806	85	2,528	248,363	1.81%
	1,620,230	**36,801**	**6,865**	**1,650,165**	**2.76%**

Total mortgage-backed securities							
Investment securities							
US Treasury securities	26,499		2		-	26,501	0.08%
Obligations of US Government sponsored agencies	15,078		35		-	15,113	1.23%
Obligations of Puerto Rico Government and political subdivisions	120,989		-		1,294	119,695	4.42%
Other debt securities	24,539		216		-	24,755	3.45%
Total investment securities	**187,105**		**253**		**1,294**	**186,064**	**3.42%**
Total securities available for sale	**$ 1,807,335**	**$**	**37,054**	**$**	**8,159**	**$ 1,836,229**	**2.83%**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

	December 31, 2012				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
	(In thousands)				
Available-for-sale					
Mortgage-backed securities					
FNMA and FHLMC certificates	$ 1,622,037	$ 71,411	$ 1	$ 1,693,447	3.06%
GNMA certificates	14,177	995	8	15,164	4.89%
CMOs issued by US Government sponsored agencies	288,409	3,784	793	291,400	1.85%
Total mortgage-backed securities	**1,924,623**	**76,190**	**802**	**2,000,011**	**2.89%**
Investment securities					
US treasury securities	26,498	-	2	26,496	0.71%
Obligations of US Government sponsored agencies	21,623	224	-	21,847	1.35%
Obligations of Puerto Rico Government and political subdivisions	120,950	9	438	120,521	3.82%
Other debt securities	25,131	280	-	25,411	3.46%
Total investment securities	**194,202**	**513**	**440**	**194,275**	2.99%
Total securities available-for-sale	**$ 2,118,825**	**$ 76,703**	**$ 1,242**	**$ 2,194,286**	**2.90%**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The amortized cost and fair value of the Company's investment securities at June 30, 2013, by contractual maturity, are shown in the next table. Securities not due on a single contractual maturity date, such as collateralized mortgage obligations, are classified in the period of final contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2013 Available-for-sale	
	Amortized Cost	Fair Value
	(In thousands)	
Mortgage-backed securities		
Due after 5 to 10 years		
FNMA and FHLMC certificates	$ 32,779	$ 33,345
Total due after 5 to 10 years	**32,779**	**33,345**
Due after 10 years		
FNMA and FHLMC certificates	1,326,055	1,357,277
GNMA certificates	10,590	11,180
CMOs issued by US Government sponsored agencies	250,806	248,363
Total due after 10 years	**1,587,451**	**1,616,820**
Total mortgage-backed securities	**1,620,230**	**1,650,165**
Investment securities		
Due in less than one year		
US Treasury securities	26,499	26,501
Other debt securities	20,000	20,058
Total due in less than one year	**46,499**	**46,559**
Due from 1 to 5 years		
Obligations of Puerto Rico Government and political subdivisions	412	399
Total due from 1 to 5 years	**412**	**399**
Due after 5 to 10 years		
Obligations of Puerto Rico Government and political subdivisions	11,425	11,053
Obligations of US Government and sponsored agencies	15,078	15,113
Total due after 5 to 10 years	**26,503**	**26,166**
Due after 10 years		
Obligations of Puerto Rico Government and political subdivisions	109,152	108,243
Other debt securities	4,539	4,697
Total due after 10 years	**113,691**	**112,940**
Total investment securities	**187,105**	**186,064**
Total securities available-for-sale	**$ 1,807,335**	**$ 1,836,229**

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The BBVAPR Acquisition and the related deleverage of the investment securities portfolio that the Company completed during the second half of 2012 reduced the interest rate risk profile of the Company. During the six-month period ended June 30, 2013, the Company did not execute any sale of securities from its portfolio other than $92.4 million of available-for-sale GNMA certificates that were sold as part of its recurring mortgage loan origination and securitization activities. These sales produced a nominal gain during such period. During the six-month period ended June 30, 2012, there were certain sales of available-for-sale securities because the Company believed that gains could be realized and that there were good opportunities to invest the proceeds in other investment securities with attractive yields and terms that would allow the Company to continue protecting its net interest margin.

The Company, as part of its asset/liability management, may purchase U.S. Treasury securities and U.S. government sponsored agency discount notes close to their maturities as alternatives to cash deposits at correspondent banks or as a short term vehicle to reinvest the proceeds of sale transactions until investment securities with attractive yields can be purchased.

For the six-month period ended June 30, 2012, the Company recorded a net gain on sale of securities of $19.3 million. The table below presents the gross realized gains by category for such period:

	Six-Month period Ended June 30, 2012			
Description	**Sale Price**	**Book Value at Sale**	**Gross Gains**	**Gross Losses**
	(In thousands)			
Sale of securities available-for-sale				
Mortgage-backed securities and CMOs				
FNMA and FHLMC certificates	$ 367,971	$ 349,400	$ 18,581	$ -
GNMA certificates	39,484	39,483	1	-
CMOs issued by US Government sponsored agencies	19,725	18,372	1,353	-
Total mortgage-backed securities and CMOs	427,180	407,255	19,935	-
Investment securities				
Obligations of U.S. Government sponsored agencies	80,000	80,000	-	