ORIENTAL FINANCIAL GROUP INC
Form 10-Q
May 08, 2009

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

(Mark One)

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

For the quarterly period ended March 31, 2009

or

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

For the transition period from __________ to __________

Commission File Number 001-12647

Oriental Financial Group Inc.

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

Principal Executive Offices:
997 San Roberto Street
Oriental Center 10th Floor
Professional Offices Park
San Juan, Puerto Rico 00926
Telephone Number: (787) 771-6800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

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

24,225,944 common shares ($1.00 par value per share) outstanding as of April 30, 2009

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FORWARD-LOOKING STATEMENTS

When used in this Form 10-Q or future filings by Oriental Financial Group Inc. (the Group) with the Securities and Exchange Commission (the SEC), in the Group s press releases or other public or shareholder communications, or in oral statements made with the approval of an authorized executive officer, the words or phrases would be, will allow, intends to, will likely result, are expected to, will continue, is anticipated, estimated, project, believe, expressions are intended to identify forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

The future results of the Group could be affected by subsequent events and could differ materially from those expressed in forward-looking statements. If future events and actual performance differ from the Group s assumptions, the actual results could vary significantly from the performance projected in the forward-looking statements.

The Group wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made and are based on management s current expectations, and to advise readers that various factors, including local, regional and national economic conditions, substantial changes in levels of market interest rates, credit and other risks of lending and investment activities, competitive, and regulatory factors, legislative changes and accounting pronouncements, could affect the Group s financial performance and could cause the Group s actual results for future periods to differ materially from those anticipated or projected. The Group does not undertake, and specifically disclaims, any obligation to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

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PART I FINANCIAL INFORMATION
ITEM I FINANCIAL STATEMENTS
UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
MARCH 31, 2009 AND DECEMBER 31, 2008
(In thousands, except share data)

	March 31, 2009	December 31, 2008
ASSETS		
Cash and due from banks	**$ 293,750**	**$ 66,372**
Investments:		
Trading securities, at fair value with amortized cost of $633 (December 31, 2008 - $255)	608	256
Investment securities available-for-sale, at fair value with amortized cost of $4,648,495 (December 31, 2008 - $4,052,574)		
Securities pledged that can be repledged	4,333,749	3,790,733
Other investment securities	221,784	133,474
Total investment securities available-for-sale	4,555,533	3,924,207
Other Investments	150	150
Federal Home Loan Bank (FHLB) stock, at cost	19,812	21,013
Total investments	**4,576,103**	**3,945,626**
Securities sold but not yet delivered	**289,565**	**834,976**
Loans:		
Mortgage loans held-for-sale, at lower of cost or fair value	34,278	26,562
Loans receivable, net of allowance for loan losses of $15,147 (December 31, 2008 - $14,293)	1,165,153	1,192,550
Total loans, net	**1,199,431**	**1,219,112**
Accrued interest receivable	38,585	43,914
Premises and equipment, net	21,540	21,184
Deferred tax asset, net	23,422	28,463
Foreclosed real estate	9,681	9,162
Investment in equity indexed options	3,052	12,801

Other assets	30,817	23,926
Total assets	**$ 6,485,946**	**$ 6,205,536**
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Demand deposits	$ 568,808	$ 453,690
Savings accounts	55,079	50,153
Certificates of deposit	1,182,359	1,281,457
Total deposits	**1,806,246**	**1,785,300**
Borrowings:		
Federal funds purchased and other short term borrowings	44,310	29,193
Securities sold under agreements to repurchase	3,757,411	3,761,121
Advances from FHLB	281,675	308,442
FDIC-guaranteed term notes	105,112	
Subordinated capital notes	36,083	36,083
Total borrowings	**4,224,591**	**4,134,839**
Securities purchased but not yet received	112,628	398
Accrued expenses and other liabilities	23,130	23,682
Total liabilities	**6,166,595**	**5,944,219**
Stockholders equity:		
Preferred stock, $1 par value; 5,000,000 shares authorized; $25 liquidation value; 1,340,000 shares of Series A and 1,380,000 shares of Series B issued and outstanding	68,000	68,000
Common stock, $1 par value; 40,000,000 shares authorized; 25,739,397 shares issued; 24,222,778 shares outstanding (December 31, 2008 - 25,739,397; 24,297,132)	25,739	25,739
Additional paid-in capital	212,784	212,625
Legal surplus	45,471	43,016
Retained earnings	71,353	51,233
Treasury stock, at cost 1,516,619 shares (December 31, 2008 - 1,442,265 shares)	(17,164)	(17,109)
Accumulated other comprehensive loss, net of tax of $1,825 (December 31, 2008 - $6,004)	(86,832)	(122,187)
Total stockholders equity	**319,351**	**261,317**
Commitments and Contingencies		
Total liabilities and stockholders equity	**$ 6,485,946**	**$ 6,205,536**

See notes to unaudited consolidated financial statements.

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UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE QUARTERS ENDED MARCH 31, 2009 AND 2008
(In thousands, except per share data)

	Quarter ended March 31, 2009	2008
Interest income:		
Loans	$ 18,320	$ 19,828
Mortgage-backed securities	50,708	39,501
Investment securities and other	14,903	22,772
Total interest income	**83,931**	**82,101**
Interest expense:		
Deposits	13,823	12,429
Securities sold under agreements to repurchase	35,799	40,240
Advances from FHLB and other borrowings	3,096	3,821
FDIC-guaranteed term notes	112	
Subordinated capital notes	436	702
Total interest expense	**53,266**	**57,192**
Net interest income	**30,665**	**24,909**
Provision for loan losses	3,200	1,650
Net interest income after provision for loan losses	**27,465**	**23,259**
Non-interest income:		
Financial service revenues	3,114	4,240
Banking service revenues	1,393	1,527
Investment banking revenues (losses)	(12)	738
Mortgage banking activities	2,153	1,006
Net gain (loss) on:		
Sale of securities	10,340	9,324
Derivatives	434	(7,803)
Trading securities	(27)	(17)
Other investments	13	100
Foreclosed real estate	(162)	(250)
Other		(1)
Total non-interest income, net	**17,246**	**8,864**
Non-interest expenses:		
Compensation and employees benefits	7,724	7,715
Occupancy and equipment	3,489	3,287

Professional and service fees	2,608	1,880
Advertising and business promotion	1,204	1,074
Insurance	815	602
Taxes, other than payroll and income taxes	646	611
Electronic banking charges	540	418
Loan servicing expenses	383	331
Communication	379	325
Directors and investor relations	349	278
Clearing and wrap fees expenses	330	294
Other	806	915
Total non-interest expenses	**19,273**	**17,730**
Income before income taxes	**25,438**	**14,393**
Income tax expense (benefit)	690	(2,455)
Net income	**24,748**	**16,848**
Less: Dividends on preferred stock	(1,201)	(1,201)
Income available to common shareholders	**$ 23,547**	**$ 15,647**
Income per common share:		
Basic	**$ 0.97**	**$ 0.65**
Diluted	**$ 0.97**	**$ 0.64**
Average common shares outstanding	24,245	24,164
Average potential common shares-options	3	125
Average diluted common shares outstanding	**24,248**	**24,289**
Cash dividends per share of common stock	**$ 0.04**	**$ 0.14**

See notes to unaudited consolidated financial statements.

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UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY FOR THE QUARTERS ENDED MARCH 31, 2009 AND 2008
(In thousands)

	Quarter Ended March 31,	
CHANGES IN STOCKHOLDERS EQUITY:	**2009**	**2008**
Preferred stock:		
Balance at beginning and end of period	**$ 68,000**	**$ 68,000**
Common stock:		
Balance at beginning of period	25,739	25,557
Stock options exercised		175
Balance at end of period	**25,739**	**25,732**
Additional paid-in capital:		
Balance at beginning of period	212,625	210,073
Stock-based compensation expense	159	73
Stock options exercised		1,910
Balance at end of period	**212,784**	**212,056**
Legal surplus:		
Balance at beginning of period	43,016	40,573
Transfer from retained earnings	2,455	1,567
Balance at end of period	**45,471**	**42,140**
Retained earnings:		
Balance at beginning of period	51,233	45,296
Net income	24,748	16,848
Cash dividends declared on common stock	(972)	(3,399)
Cash dividends declared on preferred stock	(1,201)	(1,201)
Transfer to legal surplus	(2,455)	(1,567)
Balance at end of period	**71,353**	**55,977**
Treasury stock:		
Balance at beginning of period	(17,109)	(17,023)
Stock used to match defined contribution plan 1165(e)	126	74
Stock purchased	(181)	(235)
Balance at end of period	**(17,164)**	**(17,184)**

Accumulated other comprehensive loss, net of tax:		
Balance at beginning of period	(122,187)	(13,015)
Other comprehensive income (loss), net of tax	35,355	(34,948)
Balance at end of period	**(86,832)**	**(47,963)**
Total stockholders equity	**$ 319,351**	**$ 338,758**

UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE QUARTERS ENDED MARCH 31, 2009 AND 2008
(In thousands)

	Quarter Ended March 31,	
COMPREHENSIVE INCOME	**2009**	**2008**
Net income	**$ 24,748**	**$ 16,848**
Other comprehensive income (loss):		
Unrealized gain (loss) on securities available-for-sale	49,874	(28,036)
Realized gain on investment securities available-for-sale included in net income	(10,340)	(9,324)
Income tax effect related to unrealized loss (gain) on securities available-for-sale	(4,179)	2,412
Other comprehensive income (loss) for the period	**35,355**	**(34,948)**
Comprehensive income (loss)	**$ 60,103**	**$ (18,100)**

See notes to unaudited consolidated financial statements.

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UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE QUARTERS ENDED MARCH 31, 2009 AND 2008
(In thousands)

	Quarters Ended March 31,	
	2009	2008
Cash flows from operating activities:		
Net income	$ 24,748	$ 16,848
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of deferred loan origination fees, net of costs	51	(100)
Amortization of premiums, net of accretion of discounts	740	(256)
Depreciation and amortization of premises and equipment	1,468	1,275
Deferred income tax expense (benefit)	862	(157)
Provision for loan losses	3,200	1,650
Common stock used to match defined contribution plan 1165(e)	126	74
Stock-based compensation	159	73
(Gain) loss on:		
Sale of securities available-for-sale	(10,340)	(9,324)
Mortgage banking activities	(2,153)	(1,006)
Derivatives	(434)	7,803
Sale of foreclosed real estate	162	250
Originations and purchases of loans held-for-sale	(57,553)	(28,142)
Proceeds from sale of loans held-for-sale	22,980	7,293
Net decrease (increase) in:		
Trading securities	(352)	1,029
Accrued interest receivable	5,329	15,289
Other assets	(6,891)	(5,364)
Net decrease in:		
Accrued interest on deposits and borrowings	(2,071)	(729)
Other liabilities	(544)	(1,740)
Net cash provided by (used in) operating activities	(20,513)	4,766
Cash flows from investing activities:		
Purchases of:		
Investment securities available-for-sale	(2,341,384)	(2,389,555)
Equity options	(790)	(484)
FHLB stock	(13,199)	(4,835)
Maturities and redemptions of:		
Investment securities available-for-sale	1,089,870	1,227,478
Investment securities held-to-maturity		215,533
Other investments		1,511
FHLB stock	14,400	4,835
Proceeds from sales of:		
Investment securities available-for-sale	1,360,318	713,216
Loans receivable	15,138	

Foreclosed real estate	2,728	969
Premises and equipment	5	15
Origination and purchase of loans, excluding loans held-for-sale	(29,726)	(38,097)
Principal repayments of loans	30,980	39,158
Additions to premises and equipment	(1,829)	(1,098)
Net cash provided by (used in) investing activities	126,511	(231,354)
Cash flows from financing activities:		
Net increase (decrease) in:		
Deposits	30,317	202,613
Securities sold under agreements to repurchase		(13,388)
Federal funds purchased	15,117	9,057
Proceeds from:		
Issuance of FDIC-guaranted term notes	105,000	
Advances from FHLB	760,680	248,150
Exercise of stock options		2,085
Repayments of advances from FHLB	(787,380)	(248,150)
Purchase of treasury stock	(181)	(235)
Termination of derivative instrument		(7,875)
Dividends paid on common and preferred stock	(2,173)	(4,600)
Net cash provided by financing activities	121,380	187,657
Net change in cash and due from banks	227,378	(38,931)
Cash and due from banks at beginning of period	66,372	88,983
Cash and due from banks at end of period	$ 293,750	$ 50,052
Supplemental Cash Flow Disclosure and Schedule of Noncash Activities:		
Interest paid	$ 55,337	$ 57,921
Mortgage loans securitized into mortgage-backed securities	$ 33,355	$ 12,246
Securities sold but not yet delivered	$ 289,565	$ 26,995
Securities purchased but not yet received	$ 112,628	$ 101,375
Transfer from loans to foreclosed real estate	$ 3,409	$ 1,131

See notes to unaudited consolidated financial statements.

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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 financial services industry practices.
The unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of management, these consolidated financial statements include all adjustments necessary, all of which are of normal recurring nature, to present fairly the consolidated statement of financial condition as of March 31, 2009, and December 31, 2008, and the consolidated results of operations and cash flows for the quarters ended March 31, 2009 and 2008. All significant intercompany balances and transactions have been eliminated in the accompanying unaudited consolidated financial statements. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such 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 March 31, 2009 and 2008 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, 2008, included in the Group s 2008 annual report on Form 10-K.
Nature of Operations
The Group is a publicly-owned financial holding company incorporated under the laws of the Commonwealth of Puerto Rico. It has four direct subsidiaries, Oriental Bank and Trust (the Bank), Oriental Financial Services Corp. (Oriental Financial Services), Oriental Insurance, Inc. (Oriental Insurance) and Caribbean Pension Consultants, Inc., which is located in Boca Raton, Florida. The Group also has a special purpose entity, Oriental Financial (PR) Statutory Trust II (the Statutory Trust II). Through these subsidiaries and its divisions, the Group provides a wide range of financial services such as mortgage, commercial and consumer lending, financial planning, insurance sales, money management and investment banking and brokerage services, as well as corporate and individual trust services. Note 9 to the unconsolidated financial statements presents further information about the operations of the Group s business segments.
The main offices of the Group and its subsidiaries are located in San Juan, Puerto Rico. The Group is subject to examination, regulation and periodic reporting under the U.S. Bank Holding Company Act of 1956, as amended, which is administered by the Board of Governors of the Federal Reserve System.
The Bank operates through 23 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 (OCIF) and the Federal Deposit Insurance Corporation (FDIC). The Bank offers banking services such as commercial and consumer lending, saving and time deposit products, financial planning, and corporate and individual trust services, and capitalizes on its commercial banking network to provide mortgage lending products to its clients. Oriental International Bank Inc. (OIB), a wholly-owned subsidiary of the Bank, operates as an international banking entity (IBE) pursuant to the International Banking Center Regulatory Act of Puerto Rico, as amended. OIB offers the Bank certain Puerto Rico tax advantages. OIB activities are limited under Puerto Rico law to persons and assets/liabilities located outside of Puerto Rico.
Oriental Financial Services is subject to the supervision, examination and regulation of the Financial Industry Regulatory Authority (FINRA), the SEC, and the OCIF. Oriental Insurance is subject to the supervision, examination and regulation of the Office of the Commissioner of Insurance of Puerto Rico.

The Group s mortgage banking activities are conducted through a division of the Bank. The mortgage banking activities primarily consist of the origination and purchase of residential mortgage loans for the Group s own portfolio and from time to time, if the conditions so warrant, the Group may engage in the sale of such loans to other financial institutions in the secondary market. The Group originates Federal Housing Administration (FHA)-insured and Veterans Administration (VA)-guaranteed mortgages that are primarily securitized for issuance of Government National Mortgage Association (GNMA) mortgage-backed securities which can be resold to individual or institutional investors in the secondary market. Conventional loans that meet the underwriting requirements for sale or exchange under standard Federal National Mortgage Association (the FNMA) or the Federal Home Loan Mortgage Corporation (the FHLMC) programs are referred to as conforming mortgage loans and are also securitized for issuance of FNMA or FHLMC mortgage-backed securities. The Group is an approved seller of FNMA, as well as FHLMC, mortgage loans for issuance of FNMA and FHLMC mortgage-backed securities. The Group is also an approved issuer of GNMA mortgage-backed securities. The Group continues to outsource the servicing of the GNMA, FNMA and FHLMC pools that it issues and of its mortgage loan portfolio.

Significant Accounting Policies

The unaudited consolidated financial statements of the Group are prepared in accordance with GAAP and with the general practices within the financial services industry. In preparing the 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 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.

Allowance for Loan Losses

The Group follows a systematic methodology to establish and evaluate the adequacy of the allowance for loan 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 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, other sources of cash flow and legal options available to the Group.

Included in the review of individual loans are those that are impaired, as provided in the Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan.* 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 under the provisions of SFAS No. 5, *Accounting for Contingencies* , as amended, and loans that are recorded at fair value or at the lower of cost or market. The Group measures for impairment all commercial loans over $250,000 and over 90-days past-due. The portfolios of mortgage and consumer loans are considered homogeneous, and are evaluated collectively for impairment.

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The Group, using a rating system, applies an overall allowance percentage to each loan portfolio category based on historical credit losses adjusted for current conditions and trends. This delinquency-based calculation is the starting point for management s determination of the required level of the allowance for loan losses. Other data considered in this determination includes: the overall historical loss trends and other information including underwriting standards and economic trends.

Loan loss ratios and credit risk categories are updated quarterly and are applied in the context of GAAP 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 losses, factors beyond the Group s control such as those affecting general economic conditions may require future changes to the allowance.

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.

SFAS No. 157, *Fair Value Measurements* (SFAS 157), 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 under SFAS 157 are described below:

Basis of Fair Value Measurement

Level 1- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2- Quoted prices in markets that are not considered to be active or financial instruments for which all significant inputs are observable, either directly or indirectly;

Level 3- Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

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

Impairment of Investment Securities

The Group conducts periodic reviews to identify and evaluate each investment in an unrealized loss position, in accordance with FASB Staff Position No. 115-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments (FSP FAS 115-1). An unrealized loss exists when the current fair value of an individual security is less than its amortized cost basis. Unrealized losses that are determined to be temporary in nature are recorded, net of tax, in accumulated other comprehensive income for available-for-sale securities, while such losses related to held-to-maturity securities are not recorded, as these investments are carried at their amortized cost (less any other-than-temporary impairment). Regardless of the classification of the securities as available-for-sale or held-to-maturity, the Group has assessed each position for credit impairment.

Factors considered in determining whether a loss is temporary include:

- the length of time and the extent to which fair value has been below cost;
- the severity of the impairment;
- the cause of the impairment and the financial condition and near-term prospects of the issuer;
- activity in the market of the issuer which may indicate adverse credit conditions; and

the Group s ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery.

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The Group s review for impairment generally entails:

- identification and evaluation of investments that have indications of possible other-than-temporary impairment;
- analysis of individual investments that have fair values less than amortized cost, including consideration of the length of time the investment has been in an unrealized loss position and the expected recovery period;
- discussion of evidential matter, including an evaluation of factors or triggers that could cause individual investments to qualify as having other-than-temporary impairment and those that would not support other-than-temporary impairment; and
- documentation of the results of these analyses.

The extent of the Group s analysis regarding credit quality and the stress on assumptions used in the analysis have been refined for securities where the current fair value or other characteristics of the security warrant. Given the declines in fair values and length of time in which non-agency collateralized mortgage obligations and structured credit investments have been in an unrealized loss position, general concerns regarding housing prices and the delinquency and default rates on the mortgage loans and credit spreads underlying these securities, the Group s analysis for identifying securities for which all principal and interest contractually due might not be recovered have been performed.

Income Taxes

In preparing the unconsolidated 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 rate in the year of resolution. Unfavorable settlement of any particular issue could increase the effective 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 the realizability of the deferred tax assets on a regular basis and assesses the need for a valuation allowance. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Group s tax provision in the period of change.

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

The Group follows the provisions of Financial Accounting Standard Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* , which contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation process, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

The Group s policy to include interest and penalties related to unrecognized tax benefits within the provision for taxes on the consolidated statements of operations did not change as a result of implementing the provisions of FIN 48.

Equity-Based Compensation Plans

On April 25, 2007, the Board of Directors (the Board) adopted the Oriental Financial Group Inc. 2007 Omnibus Performance Incentive Plan (the Omnibus Plan), which was subsequently approved by the Group s stockholders at their annual meeting held on June 27, 2007. 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 purpose of the Omnibus Plan is to provide flexibility to the Group to attract, retain and motivate directors, officers, and key employees through the grant of awards based on performance and to adjust its compensation practices to the best compensation practice and corporate governance trends as they develop from time to time. The Omnibus Plan is further intended to motivate high levels of individual performance coupled with increased shareholder returns. Therefore, awards under the Omnibus Plan (each, an Award) are intended to be based upon the recipient s individual performance, level of responsibility and potential to make significant contributions to the Group. Generally, the Omnibus Plan will terminate as of (a) the date when no more of the Group s shares of common stock are available for issuance under the Omnibus Plan, or, if earlier, (b) the date the Omnibus Plan is terminated by the Group s Board.

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. Only the Committee may exercise authority in respect of Awards granted to such participants.

The Omnibus Plan replaced and superseded the Oriental Financial Group Inc. 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 Group follows the fair value method of recording stock-based compensation. Effective July 1, 2005, the Group adopted SFAS No. 123R *Share-Based Payment* (SFAS 123R), an amendment of SFAS No. 123 Accounting for Stock-Based Compensation using the modified prospective transition method. SFAS 123R 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. SFAS No. 123R applies to all awards unvested and granted after this effective date and awards modified, repurchased, or cancelled after that date.

The following assumptions were used in estimating the fair value of the options granted:

	Quarter Ended March 31,	
	2009	**2008**
Weighted Average Assumptions:		
Dividend yield	4.64%	4.40%
Expected volatility	33.60%	31.86%
Risk-free interest rate	4.49%	4.33%
Expected life (in years)	8.5	8.5

The expected term of share options granted represents the period of time that share options granted are expected to be outstanding. Expected volatilities are based on historical volatility of the Group s shares over the most recent period equal to the expected term of the share option.

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Recent Accounting Developments:

FASB Staff Position (FSP) FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

FSP FAS 157-4, issued by the FASB in April 2009, provides additional guidance for estimating fair value in accordance with SFAS No. 157 when the volume and level of activity for the asset or liability have decreased significantly. FSP FAS 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly. The provisions of FSP FAS 157-4 are effective for the Group s interim period ending after June 15, 2009, but entities may early adopt for the interim and annual periods ending after March 15, 2009. Management decided not to do an early adoption, and is currently evaluating the effect that the provisions of FSP FAS 157-4 may have on the Group s statements of financial condition and income.

FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments

FSP FAS 115-2 and FAS 124-2, issued by the FASB in April 2009, amend the other-than-temporary impairment guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. These FSPs do not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The provisions of FSP FAS 115-2 and FAS 124-2 are effective for the Group s interim period ending after June 15, 2009, but entities may early adopt for the interim and annual periods ending after March 15, 2009. Management decided not to do an early adoption, and is currently evaluating the effect that the provisions of FSP FAS 115-2 and FAS 124-2 may have on the Group s statements of financial condition and income.

FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments

FSP FAS 107-1 and APB 28-1, issued by the FASB in April 2009, amend FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. These FSPs also amend APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in summarized financial information at interim reporting periods. The provisions of FSP FAS 107-1 and APB 28-1 are effective for the Group s interim period ending after June 15, 2009, but entities may early adopt for the interim and annual periods ending after March 15, 2009. Management decided not to do an early adoption, but as FSP FAS 107-1 and APB 28-1 amend only the disclosure requirements about fair value of financial instruments in interim periods, the adoption of FSP FAS 107-1 and APB 28-1 is not expected to affect the Group s statements of financial condition and income.

NOTE 2 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 March 31, 2009, and December 31, 2008, cash equivalents included as part of cash and due from banks amounted to $270.9 million and $52.0 million, respectively.

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Investment Securities

The amortized cost, gross unrealized gains and losses, fair value, and weighted average yield of the investment securities as of March 31, 2009, and December 31, 2008, were as follows:

	March 31, 2009 (In thousands)				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Available-for-sale					
Obligations of US Government sponsored agencies	$ 664,146	$ 5,451	$ 54	$ 669,543	5.98%
Puerto Rico Government and agency obligations	80,616	5	8,227	72,394	5.39%
Structured credit investments	176,536	1,597	44,318	133,815	3.57%
Total investment securities	**921,298**	**7,053**	**52,599**	**875,752**	
FNMA and FHLMC certificates	2,146,614	44,540	57	2,191,097	4.95%
GNMA certificates	301,198	8,894	206	309,886	5.38%
CMOs issued by US Government sponsored agencies	660,153	17,402		677,555	5.32%
Non-agency collateralized mortgage obligations	619,232		117,989	501,243	8.43%
Total mortgage-backed-securities and CMOs	**3,727,197**	**70,836**	**118,252**	**3,679,781**	
Total securities available-for-sale	**$ 4,648,495**	**$ 77,889**	**$ 170,851**	**$ 4,555,533**	**5.60%**

	December 31, 2008 (In thousands)				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Available-for-sale					
Obligations of US Government sponsored agencies	$ 941,144	$ 7,172	$ 6,400	$ 941,916	5.37%
Puerto Rico Government and agency obligations	91,599	597	9,307	82,889	5.40%
Structured credit investments	176,127	3,469	43,415	136,181	4.25%
Total investment securities	**1,208,870**	**11,238**	**59,122**	**1,160,986**	
FNMA and FHLMC certificates	1,521,428	25,527	205	1,546,750	5.51%
GNMA certificates	332,071	4,206	496	335,781	5.76%
CMOs issued by US Government sponsored agencies	352,579	202	1,755	351,026	5.34%
Non-agency collateralized mortgage obligations	637,626		107,962	529,664	8.49%

Total mortgage-backed-securities and CMOs	**2,843,704**	**29,935**	**110,418**	**2,763,221**	
Total securities available-for-sale	**$ 4,052,574**	**$ 41,173**	**$ 169,540**	**$ 3,924,207**	**5.90%**

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The amortized cost and fair value of the Group s investment securities available-for-sale at March 31, 2009, 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.

	(In thousands) Available-for-sale	
	Amortized Cost	**Fair Value**
Investment securities		
Due after 1 to 5 years	$ 9,000	$ 9,000
Due after 5 to 10 years	228,747	213,952
Due after 10 years	683,551	652,800
	921,298	**875,752**
Mortgage-backed securities		
Due after 5 to 10 years	21,427	21,754
Due after 10 years	3,705,770	3,658,027
	3,727,197	**3,679,781**
	$4,648,495	**$4,555,533**

Keeping with the Group s investment strategy, during the quarters ended March 31, 2009 and 2008, 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. Also, the Group, as part of its asset and liability management, purchases agency discount notes close to their maturities as a short term vehicle to reinvest the proceeds of sales transactions until similar investment securities with attractive yields can be purchased. The discount notes are pledged as collateral for repurchase agreements. During the quarter ended March 31, 2009, the Group sold $260.0 million of discount notes with minimum aggregate gross gains of approximately $4,000 and sold $107.0 million of discount notes with minimum aggregate gross losses of approximately $4,000.

The table below presents an analysis on a trade date accounting of the gross realized gains and losses by category for the quarters ended March 31, 2009 and 2008:

Quarter ended March 31, 2009

In thousands

Description	**Original Face**	**Original Cost**	**Sale Price**	**Sale Book Value**	**Gross Gains**	**Gross Losses**
Sale of Securities Available-for-Sale						
Investment securities						
	$ 11,000	$ 11,000	$ 11,000	$ 11,000	$	$

Puerto Rico Government and agency obligations						
Obligations of U.S. Government sponsored agencies	366,000	366,000	365,981	365,981	4	4
Total investment securities	377,000	377,000	376,981	376,981	4	4
Mortgage-backed securities and CMOs						
FNMA and FHLMC certificates	458,053	459,756	421,181	410,889	10,292	
GNMA certificates	40,085	40,588	40,625	40,577	48	
Total mortgage-backed securities and CMOs	498,138	500,344	461,806	451,466	10,340	
Total	$875,138	$877,344	$838,787	$ 828,447	$10,344	$4

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Quarter ended March 31, 2008

In thousands Description	Original Face	Original Cost	Sale Price	Sale Book Value	Gross Gains	Gross Losses
Sale of Securities Available-for-Sale						
Investment securities						
Puerto Rico Government and agency obligations	$ 830	$ 833	$ 852	$ 837	$ 15	$
Obligations of U.S. Government sponsored agencies	695,000	694,665	703,968	694,747	9,221	
Total investment securities	695,830	695,498	704,820	695,584	9,236	
Mortgage-backed securities and CMOs						
GNMA certificates	9,959	10,225	8,396	8,308	88	
Total mortgage-backed securities and CMOs	9,959	10,225	8,396	8,308	88	
Total	**$705,789**	**$705,723**	**$713,216**	**$ 703,892**	**$9,324**	**$**

The following table shows 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 March 31, 2009, and December 31, 2008.

March 31, 2009

Available-for-sale

(In thousands)

	Less than 12 months		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
Non-agency collaterized mortgage obligations	$ 20,586	$ 2,610	$ 17,976
Structured credit investments	29,272	2,129	27,143
Obligations of US Government sponsored agencies	19,285	54	19,231
GNMA certificates	3,920	29	3,891
FNMA and FHLMC certificates	6,350	16	6,334
	79,413	**4,838**	**74,575**

	12 months or more		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
Non-agency collaterized mortgage obligations	598,646	115,379	483,267
Structured credit investments	121,717	42,189	79,528
Puerto Rico Government and agency obligations	71,236	8,227	63,009
GNMA certificates	8,934	177	8,757
FNMA and FHLMC certificates	1,011	41	970
	801,544	**166,013**	**635,531**

	Total		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
Non-agency collaterized mortgage obligations	619,232	117,989	501,243
Structured credit investments	150,989	44,318	106,671
Puerto Rico Government and agency obligations	71,236	8,227	63,009
Obligations of US Government sponsored agencies	19,285	54	19,231
GNMA certificates	12,854	206	12,648
FNMA and FHLMC certificates	7,361	57	7,304
	$ 880,957	**$ 170,851**	**$ 710,106**

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December 31, 2008

Available-for-sale

(In thousands)

	Less than 12 months		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
Non-agency collaterized mortgage obligations	$ 234,198	$ 48,564	$ 185,634
CMOs issued by US Government sponsored agencies	334,690	1,756	332,934
Obligations of US Government sponsored agencies	325,500	6,400	319,100
Structured credit investments	50,262	11,815	38,447
Puerto Rico Government and agency obligations	252	1	251
FNMA and FHLMC certificates	52,519	148	52,371
GNMA certificates	19,582	229	19,353
	1,017,003	**68,913**	**948,090**

	12 months or more		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
Non-agency collaterized mortgage obligations	403,428	59,398	344,030
Structured credit investments	100,548	31,599	68,949
Puerto Rico Government and agency obligations	71,218	9,306	61,912
FNMA and FHLMC certificates	1,025	57	968
GNMA certificates	9,084	267	8,817
	585,303	**100,627**	**484,676**

	Total		
	Amortized Cost	**Unrealized Loss**	**Fair Value**
Non-agency collaterized mortgage obligations	637,626	107,962	529,664
CMOs issued by US Government sponsored agencies	334,690	1,756	332,934
Obligations of US Government sponsored agencies	325,500	6,400	319,100
Structured credit investments	150,810	43,414	107,396
Puerto Rico Government and agency obligations	71,470	9,307	62,163
FNMA and FHLMC certificates	53,544	205	53,339
GNMA certificates	28,666	496	28,170
	$ 1,602,306	**$ 169,540**	**$ 1,432,766**

At March 31, 2009, the Group s available-for-sale investment securities portfolio included approximately $619.2 million in non-agency collateralized mortgage obligations with unrealized losses of approximately $118.0 million. The Group constantly monitors such non-agency mortgage-backed securities to measure the collateral performance and gauge trends for these positions, and the effect of collateral behavior on credit enhancements, cash flows, and fair values of the bonds. The Group also periodically monitors any rating migration, and takes into account the time lag between underlying performance and rating agency actions. The collateral for all of the non-agency collateralized mortgage obligations, except for the ALT A CMO which is more thoroughly discussed below, has performed well since the issuance of each security, and the estimated future collateral losses are lower than the subordination levels of these securities. This assessment is made using a cash flow model that estimates the cash flows on the underlying mortgages, based on the security-specific collateral and deal structure, and also includes inputs such as constant default rates, prepayment rates, and loss severity. The cash flows estimated by the model are distributed through the different tranches of each security, considering subordination for the different tranches. The model results as of March 31, 2009 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.

In the specific case of the ALT A CMO, this security has been carefully monitored during the past year. As of September 30, 2008, the Group considered that the deterioration in the performance of underlying loans, including increases in delinquency and loss experience, resulted in projected losses which exceeded the tranche subordination. As a result, an other than temporary impairment amounting to $38.9 million was recorded at that time. As of March 31, 2009, the Group updated its estimate of fair value of the security considering new market conditions. Based on the Group s estimate using market participant data, projected losses in excess of remaining subordination at that date were not greater that the estimated losses contemplated by projected cash flow estimates determined upon previous impairment of the security. Consequently, the Group has determined that no additional impairment charge is necessary as of March 31, 2009.

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At March 31, 2009, the Group held structured credit investments amounting to $176.5 million in the available-for-sale portfolio, with net unrealized losses of approximately $42.7 million. The Group s structured credit investments portfolio consist of two types of instruments: synthetic collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). At March 31, 2009, the Group estimated that it will recover all interest and principal for the Group s specific tranches of these securities. This assessment is based on an analysis in which the credit quality of the Group s positions was evaluated through a determination of the expected losses on the underlying collateral. The losses on the underlying corporate pools were inferred by observations on the credit spreads of the reference entities or market quotes used to derive the credit spreads. The spreads of the portfolios were converted to loss probabilities, and these were applied to a cash flow model that provided estimated projected losses for each security. The model results as of March 31, 2009 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.

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.

Other securities in an unrealized loss position at March 31, 2009, are mainly composed of securities issued or backed by U.S. government agencies and U.S. government sponsored agencies. These investments are primarily highly liquid securities that have a large and efficient secondary market. Valuations are performed on a monthly basis using a third party provider and dealer quotes. The Group s management believes that the unrealized losses of such other securities at March 31, 2009, are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuer or guarantor. At March 31, 2009, the Group has the intent and ability to hold these investments until a period of time sufficient to allow for any recovery in fair value or maturity up to (or beyond) the cost of these investments.

NOTE 3 PLEDGED ASSETS

At March 31, 2009, residential mortgage loans amounting to $606.4 million were pledged to secure advances and borrowings from the FHLB. Investment securities with fair values totaling $4.206 billion, $83.9 million, and $43.8 million at March 31, 2009, were pledged to secure securities sold under agreements to repurchase, public fund deposits and other funds, respectively. Also, investment securities with fair value totaling $114,000 at March 31, 2009, were pledged to the Puerto Rico Treasury Department.

As of March 31, 2009, investment securities available-for-sale not pledged amounted to $221.8 million. As of March 31, 2009, mortgage loans not pledged amounted to $392.8 million.

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NOTE 4 LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loans

The Group s credit activities are mainly with customers located in Puerto Rico. The Group s loan transactions are encompassed within three main categories: mortgage, commercial and consumer. The composition of the Group s loan portfolio at March 31, 2009, and December 31, 2008, was as follows:

	(In thousands)	
	March 31, 2009	December 31, 2008
Loans secured by real estate:		
Residential mortgage loans	$ 945,753	$ 976,569
Home equity loans, secured personal loans and others	22,581	23,507
Commercial	124,572	145,377
Deferred loan fees, net	(3,340)	(3,197)
	1,089,566	1,142,256
Other loans:		
Commercial	69,573	41,700
Personal consumer loans and credit lines	21,330	23,054
Deferred loan fees, net	(169)	(167)
	90,734	64,587
Loans receivable	**1,180,300**	**1,206,843**
Allowance for loan losses	(15,147)	(14,293)
Loans receivable, net	1,165,153	1,192,550
Mortgage loans held-for-sale	34,278	26,562
Total loans, net	**$ 1,199,431**	**$ 1,219,112**

Allowance for Loan Losses

The Group maintains an allowance for loan 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 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. Refer to Table 4 of the Management s Discussion and Analysis of Financial Condition and Results of Operations for additional details related to the changes in the allowance for loan losses for the quarters ended March 31, 2009 and 2008.

The Group evaluates all loans, some individually, and others as homogeneous groups, for purposes of determining impairment. At March 31, 2009, and December 31, 2008, the total balance of impaired commercial loans was $7.7 million and $4.6 million, respectively. The impaired commercial loans were measured based on the fair value of collateral. The Group s management determined that impaired loans required a valuation allowance in accordance with FASB Statement No. 114 *Accounting by Creditors for Impairment of a Loan* of approximately $1.0 million at March 31, 2009. No allowance was required at March 31, 2008.

NOTE 5 OTHER ASSETS

Other assets at March 31, 2009, and December 31, 2008 consist of the following:

	(In thousands)	
	March 31, 2009	December 31, 2008
Mortgage tax credits	$ 5,047	$ 5,047
Debt issuance costs	4,381	900
Servicing asset	3,467	2,819
Prepaid expenses	2,817	3,433
Goodwill	2,006	2,006
Investment in Statutory Trust	1,086	1,086
Accounts receivable and other assets	12,013	8,635
	$ 30,817	**$ 23,926**

NOTE 6 BORROWINGS

Short Term Borrowings

At March 31, 2009, short term borrowings amounted to $44.3 million (December 31, 2008 $29.2 million) which mainly consist of federal funds purchased with a weighted average rate of 0.70% (December 31, 2008 1.49%).

Securities Sold under Agreements to Repurchase

At March 31, 2009, 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 March 31, 2009, securities sold under agreements to repurchase (classified by counterparty), excluding accrued interest in the amount of $7.4 million, were as follows:

	(In thousands)	
	Borrowing Balance	Fair Value of Underlying Collateral
Citigroup	$ 1,800,000	$ 2,138,365
Credit Suisse First Boston Corporation	1,250,000	1,430,626
UBS Financial Services	500,000	589,334
JP Morgan Chase	100,000	109,565
Merrill Lynch	100,000	110,505
Total	**$ 3,750,000**	**$ 4,378,395**

The fair value of underlying collateral includes agency-issued investment securities with a fair value of $289.6 million sold on March 31, 2009 for which the transaction settled after that date. The proceeds from such sale were reinvested after quarter-end in similar quality agency-issued securities, which were then placed as collateral for the corresponding repurchase agreements.

The terms of the Group s structured repurchase agreements range between three and ten years, and the counterparts have the right to exercise put options before their contractual maturity from one to three years after the agreements settlement dates. The following table shows a summary of these agreements and their terms, excluding accrued interest in the amount of $7.4 million, at March 31, 2009:

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Year of Maturity	(In thousands) Borrowing Balance	Weighted-Average Coupon	Settlement Date	Maturity Date	Next Put Date
2010					
	$ 100,000	4.39%	8/14/2007	8/16/2010	5/14/2009
	100,000				
2011					
	100,000	4.17%	12/28/2006	12/28/2011	6/28/2009
	350,000	4.23%	12/28/2006	12/28/2011	6/28/2009
	100,000	4.29%	12/28/2006	12/28/2011	6/28/2009
	350,000	4.35%	12/28/2006	12/28/2011	6/28/2009
	900,000				
2012					
	350,000	4.26%	5/9/2007	5/9/2012	5/9/2009
	100,000	4.50%	8/14/2007	8/14/2012	8/14/2009
	300,000	4.47%	9/13/2007	9/13/2012	9/13/2009
	150,000	4.31%	3/6/2007	12/6/2012	12/7/2009
	900,000				
2014					
	100,000	4.67%	7/27/2007	7/27/2014	1/27/2010
	100,000				
2017	500,000	4.46%	3/2/2007	3/2/2017	6/2/2009
	250,000	0.25%	3/2/2007	3/2/2017	6/2/2009
	1,000,000	0.00%	3/6/2007	3/6/2017	6/6/2009
	1,750,000				
	$ 3,750,000	2.93%			

The structured repurchase agreements include $1.25 billion, which reset at the 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 0.0% (from March 6, 2009) and 0.25% (from March 2, 2009) to at least their next put dates scheduled for June 2009.

Advances from the Federal Home Loan Bank

During 2007, the Group restructured most of its FHLB advances portfolio into longer-term, structured advances. The terms of these advances range between five and seven years, and the FHLB has the right to exercise put options before the contractual maturity of the advances from six 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 $1.7 million, at March 31, 2009:

	(In thousands)				
Year of Maturity	Borrowing Balance	Weighted-Average Coupon	Settlement Date	Maturity Date	Next Put Date
2012					
	$ 25,000	4.37%	5/4/2007	5/4/2012	5/5/2009
	25,000	4.57%	7/24/2007	7/24/2012	4/24/2009
	25,000	4.26%	7/30/2007	7/30/2012	4/30/2009
	50,000	4.33%	8/10/2007	8/10/2012	5/10/2009
	100,000	4.09%	8/16/2007	8/16/2012	5/16/2009
	225,000				
2014					
	25,000	4.20%	5/8/2007	5/8/2014	5/8/2009
	30,000	4.22%	5/11/2007	5/11/2014	5/13/2009
	55,000				
	$ 280,000	4.24%			

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None of the structured advances from the FHLB referred above with put dates up to May 4, 2009 were put by the counterparty at their corresponding put dates.

Subordinated Capital Notes

Subordinated capital notes amounted to $36.1 million at March 31, 2009, and December 31, 2008.

In October 2001 and August 2003, the Statutory Trust I and the Statutory Trust II, respectively, special purpose entities of the Group, were formed for the purpose of issuing trust redeemable preferred securities. In December 2001 and September 2003, $35.0 million of trust redeemable preferred securities were issued by each of the Statutory Trust I and the Statutory Trust II, respectively, as part of pooled underwriting transactions. 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 these issuances were used by the Statutory Trust I and the Statutory Trust II to purchase a like amount of floating rate junior subordinated deferrable interest debentures (subordinated capital notes) issued by the Group. The call provision of the subordinated capital note purchased by the Statutory Trust I was exercised by the Group in December 2006. The other subordinated capital note has a par value of $36.1 million, bears interest based on 3-month LIBOR plus 295 basis points (4.27% at March 31, 2009; 4.82% at December 31, 2008), 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 June 2009). The trust redeemable preferred securities have the same maturity and call provisions as the subordinated capital notes. The subordinated deferrable interest debentures issued by the Group are accounted for as a liability denominated as subordinated capital notes on the unaudited consolidated statements of financial condition.

The subordinated capital notes are 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.

Temporary Liquidity Guarantee Program

The Group s banking subsidiary issued in March 2009 $105 million in notes guaranteed under the FDIC Temporary Liquidity Guarantee Program. These notes are due on March 16, 2012, bear interest at a 2.75% fixed rate, and are backed by the full faith and credit of the United States. Interest on the notes is payable on the 16th of each March and September, beginning September 16, 2009. Shortly after issuance of the notes, the Group paid $3.2 million (equivalent to an annual fee of 100 basis points) to the FDIC to maintain the FDIC guarantee coverage until the maturity of the notes.

NOTE 7 DERIVATIVE ACTIVITIES

The Group may use various derivative instruments as part of its asset and liability management. These transactions involve both credit and market risks. The notional amounts are amounts on which calculations, payments, and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. The actual risk of loss is the cost of replacing, at market, these contracts in the event of default by the counterparties. The Group controls the credit risk of its derivative financial instrument agreements through credit approvals, limits, monitoring procedures and collateral, when considered necessary.

Derivative instruments are generally negotiated over-the-counter (OTC) contracts. Negotiated OTC derivatives are generally entered into between two counterparties that negotiate specific contractual terms, including the underlying instrument, amount, exercise price and maturity.

The Group generally uses interest rate swaps and options in managing its interest rate risk exposure. Certain swaps were entered into to convert the forecasted rollover of short-term borrowings into fixed rate liabilities for longer periods and provide protection against increases in short-term interest rates. Under these swaps, the Group paid a fixed monthly or quarterly cost and received a floating thirty or ninety-day payment based on LIBOR. Floating rate payments received from the swap counterparties partially offset the interest payments to be made on the forecasted rollover of short-term borrowings.

During the quarter ended March 31, 2008, losses of $7.8 million were recognized and reflected as Derivatives Activities in the unaudited consolidated statements of operations. This was mainly due to an interest-rate swap contract that the Group entered into to manage the Group s interest rate risk exposure with a notional amount of $500 million. Such contract was terminated in January 2008, resulting in a loss to the Group of approximately $7.9 million.

The Group offers its customers certificates of deposit with an option tied to the performance of the Standard & Poor s 500 stock market 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 in accordance with SFAS No. 133, as amended.

There were no derivatives designated as a hedge as of March 31, 2009, and December 31, 2008. At March 31, 2009, and December 31, 2008, the purchased options used to manage the exposure to the stock market on stock indexed deposits represented an asset of $3.1 million (notional amount of $154.2 million) and $12.8 million (notional amount of $155.4 million), respectively; the options sold to customers embedded in the certificates of deposit and recorded as deposits in the unaudited consolidated statement of financial condition, represented a liability of $6.5 million (notional amount of $149.0 million) and $16.6 million (notional amount of $149.8 million), respectively.

NOTE 8 INCOME TAX

Under the Puerto Rico 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 alternative minimum tax (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.

The Group maintained an effective tax rate lower than the maximum marginal statutory rate of 40.95% and 39% as of March 31, 2009 and 2008, respectively, mainly due to the interest income arising from investments exempt from Puerto Rico income taxes, net of expenses attributable to the exempt income. Exempt interest relates mostly to interest earned on obligations of the United States and Puerto Rico governments and certain mortgage-backed securities, including securities held by the Bank s international banking entity. Pursuant to the Declaration of Fiscal Emergency and Omnibus Plan for Economic Stabilization and Restoration of the Puerto Rico Credit Act of March 9, 2009, for tax years beginning after December 31, 2008, and ending before January 1, 2012, every taxable corporation engaged in trade or business in Puerto Rico, including banks and insurance companies will be subject to an additional five percent (5%) surcharge on corporate income tax, increasing the maximum tax rate from 39% to 40.95%. Also, income earned by international banking entities, which was previously exempt, will be subject to a 5% income tax during the same period. These temporary taxes were enacted as a measure to generate additional revenues to address the fiscal crisis that the government of Puerto Rico is currently facing. Income tax expense for the quarter ended March 31, 2009 includes approximately $950,000 related to these tax impositions.

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 the realizability of the deferred tax assets on a regular basis and assesses the need for a valuation allowance. Total gross deferred tax asset at March 31, 2009 amounts to $26.7 million. 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. As of March 31, 2009, a valuation allowance of approximately $1.1 million was recorded to offset deferred tax asset that the Group believes it is more likely than not would be realized in future periods.

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

The Group follows the provisions of Financial Accounting Standard Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* , which contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation process, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

The total amount of gross unrecognized tax benefits as of the date of adoption that would affect the effective tax rate was $5.8 million. The Group classifies unrecognized tax benefits in income taxes payable. These gross unrecognized tax benefits would affect the effective tax rate if realized. For the quarter ended March 31, 2009,

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($325,000) (March 31, 2008 $2.4 million) in unrecognized tax (losses) benefits expired due to statute of limitation. There were no new or settled unrecognized tax benefits during the quarter. The balance of unrecognized tax benefits at March 31, 2009 was $4.3 million (December 31, 2008 $4.0 million). The tax periods ended June 30, 2005, December 31, 2005, and 2006, remain subject to examination by the Puerto Rico Department of Treasury.

The Group s policy to include interest and penalties related to unrecognized tax benefits within the provision for taxes on the consolidated statements of operations did not change as a result of implementing the provisions of FIN 48. The Group had accrued $1.7 million at March 31, 2009 (December 31, 2008-$1.5 million) for the payment of interest and penalties relating to unrecognized tax benefits. On January 13, 2009, $325,000 in unrecognized tax losses expired due to statute of limitation. The Group does not anticipate any other significant changes in unrecognized tax benefits during 2009.

NOTE 9 FAIR VALUE

As discussed in Note 1, effective January 1, 2008, the Group adopted SFAS 157, which provides a framework for measuring fair value under GAAP.

Fair Value Measurement

SFAS 157 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. SFAS 157 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 that may be used to measure fair value:

Level 1 - Level 1 asset 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 (e.g. callable brokered CDs and medium-term notes elected for fair value option under SFAS 159) whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

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

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The following is a description of the valuation methodologies used for instruments measured at fair value:

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 and non-agency collateralized mortgage obligations are not trading actively in the current market; accordingly, they do not exhibit readily observable prices. Based on their valuation methodology, such investments are classified as Level 3. The estimated fair value of the structured credit investments and the non-agency collateralized mortgage obligations are 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, delinquency, and loss rates. The assumptions used are drawn from a combination of internal and external data sources. A third-party valuation of these investments, in which all economic assumptions are determined by this third-party (external-based valuation), is obtained at least on a quarterly basis and is used by management as a benchmark to evaluate the adequacy of the cash flow model and the reasonableness of the assumptions and fair value estimates developed internally for the internal-based valuation. The external-based valuations are analyzed and assumptions are evaluated and incorporated in the internal-based valuation model when deemed necessary and agreed by management.

Derivative instruments

The fair values of the derivative instruments were 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 offers its customers certificates of deposit with an option tied to the performance of the Standard & Poor s 500 stock market index (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 from counterparties or an external pricing source and validated by management. Based on their valuation methodology, derivative instruments are classified as Level 3. These options are mainly tied in to Asian options whose payoff 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 used, which are uncertain and require a degree of judgment, include primarily S&P Index volatility and leverage. The external-based valuations are analyzed and assumptions are evaluated and incorporated in either an internal-based valuation model when deemed necessary or compared to counterparties prices and agreed by management.

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

	March 31, 2009 Fair Value Measurements		
(In thousands)	Level 1	Level 2	Level 3
Investment securities available-for-sale	$	$ 3,920,475	$ 635,058
Money market investments	270,909		
Derivative asset			3,052
Derivative liability			(6,513)
	$ 270,909	$ 3,920,475	$ 631,597

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The table below presents a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the quarter ended March 31, 2009.

Level 3 Instruments Only *(In thousands)*	**Total Fair Value Measurements (Quarter ended March 31, 2009)** Investment securities available-for-sale	Derivative asset	Derivative liability
Balance at beginning of period	$665,845	$ 12,801	$(16,588)
Gains (losses) included in earnings		(10,117)	10,551
Gains (losses) included in other comprehensive income	(12,802)		
New instruments acquired		947	(898)
Principal repayments and amortization	(17,985)	(579)	422
Transfers in and/or out of Level 3			
Balance at end of period	$635,058	$ 3,052	$ (6,513)

The table below presents a detail of investment securities available-for-sale classified as level 3 at March 31, 2009 and December 31, 2008.

	March 31, 2009 (In thousands)				
Type	**Amortized Cost**	**Unrealized Losses**	**Fair Value**	**Weighted Average Yield**	**Principal Protection**
Non-agency collateralized mortgage obligations					
Prime Collateral	$ 200,273	$ 40,522	$ 159,751	5.78%	4.48%
Prime Collateral	185,726	19,912	165,814	5.52%	4.48%
Alt-A Collateral	118,439	40,204	78,235	19.78%	12.41%
Prime Collateral	25,114	3,192	21,922	6.11%	4.15%
Prime Collateral	24,610	3,824	20,786	6.21%	9.95%
Prime Collateral	22,491	3,967	18,524	5.61%	6.85%
Prime Collateral	21,993	3,758	18,235	5.84%	5.08%
Prime Collateral	20,586	2,610	17,976	6.42%	3.77%
	619,232	117,989	501,243	8.43%	
Structured credit investments					
CDO	114,819	16,517	98,302	3.23%	4.41%
CDO	25,548	12,480	13,068	5.80%	7.80%
CLO	15,000	5,329	9,671	3.38%	7.44%
CLO	11,969	4,805	7,164	2.57%	26.14%
CLO	9,200	3,590	5,610	2.94%	22.75%

176,536	42,721	133,815	3.57%
$ 795,768	$ 160,710	$ 635,058	7.35%

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	December 31, 2008 (In thousands)		
			Weighted
Amortized	Unrealized		