

ORIENTAL FINANCIAL GROUP INC

Form 10-Q

August 08, 2008

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

(Mark One)

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

For the quarterly period ended June 30, 2008

or

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

For the transition period from _____ to _____

**Commission File Number 001-12647
Oriental Financial Group Inc.**

Incorporated in the Commonwealth of Puerto Rico.

IRS Employer Identification No. 66-0538893

Principal Executive Offices:

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

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

Yes 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 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 Accelerated filer 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

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

24,292,786 common shares (\$1.00 par value per share)
outstanding as of July 31, 2008

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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.

Table of Contents**PART I FINANCIAL INFORMATION****ITEM I FINANCIAL STATEMENTS****UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****JUNE 30, 2008 AND DECEMBER 31, 2007***(In thousands, except share data)*

	June 30, 2008	December 31, 2007
ASSETS		
Cash and due from banks	\$ 56,486	\$ 88,983
Investments:		
Trading securities, at fair value with amortized cost of \$1,298 (December 31, 2007 \$1,103)	1,311	1,122
Investment securities available-for-sale, at fair value with amortized cost of \$3,467,005 (December 31, 2007 \$3,063,763)		
Securities pledged that can be repledged	3,213,381	2,903,078
Other investment securities	168,926	166,204
Total investment securities available-for-sale	3,382,307	3,069,282
Investment securities held-to-maturity, at amortized cost with fair value of \$1,198,736 (December 31, 2007 \$1,478,112)		
Securities pledged that can be repledged	1,161,754	1,348,159
Other investment securities	76,393	144,728
Total investment securities held-to-maturity	1,238,147	1,492,887
Federal Home Loan Bank (FHLB) stock, at cost	22,062	20,658
Other investments	150	1,661
Total investments	4,643,977	4,585,610
Loans:		
Mortgage loans held-for-sale, at lower of cost or market	42,122	16,672
Loans receivable, net of allowance for loan losses of \$11,885 (December 31, 2007 \$10,161)	1,176,035	1,162,894
Total loans, net	1,218,157	1,179,566
Accrued interest receivable	42,842	52,315
Premises and equipment, net	21,378	21,779

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Deferred tax asset, net	17,249	10,362
Foreclosed real estate	4,906	4,207
Investment in equity indexed options	27,641	40,709
Other assets	27,543	16,324
Total assets	\$ 6,060,179	\$ 5,999,855

LIABILITIES AND STOCKHOLDERS EQUITY

Deposits:

Demand deposits	\$ 124,140	\$ 119,152
Savings accounts	407,911	387,790
Certificates of deposit	960,368	739,478

Total deposits	1,492,419	1,246,420
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Borrowings:

Federal funds purchased and other short term borrowings	41,583	27,460
Securities sold under agreements to repurchase	3,810,752	3,861,411
Advances from FHLB	331,895	331,898
Subordinated capital notes	36,083	36,083

Total borrowings	4,220,313	4,256,852
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Securities purchased but not yet received	23,103	111,431
Accrued expenses and other liabilities	23,177	25,691

Total liabilities	5,759,012	5,640,394
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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; 25,736,121 shares issued; 24,292,086 shares outstanding (December 31, 2007-25,555,575; 24,120,771)	25,736	25,557
Additional paid-in capital	212,282	210,073
Legal surplus	43,533	40,573
Retained earnings	64,406	45,296
Treasury stock, at cost 1,444,035 shares (December 31, 2007 1,436,426 shares)	(17,136)	(17,023)
Accumulated other comprehensive loss, net of tax of \$4,402 (December 31, 2007 \$2,166)	(95,654)	(13,015)

Total stockholders equity	301,167	359,461
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Commitments and Contingencies

Total liabilities and stockholders equity	\$ 6,060,179	\$ 5,999,855
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See notes to unaudited consolidated financial statements.

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UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2008 AND 2007
(In thousands, except per share data)

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2008	2007	2008	2007
Interest income:				
Loans	\$ 19,682	\$ 22,315	\$ 39,510	\$ 44,163
Mortgage-backed securities	47,765	25,268	87,266	50,766
Investment securities and other	17,711	23,218	40,483	37,371
Total interest income	85,158	70,801	167,259	132,300
Interest expense:				
Deposits	12,265	13,601	24,694	25,849
Securities sold under agreements to repurchase	40,208	36,546	80,448	69,334
Advances from FHLB, term notes and other borrowings	3,716	2,198	7,537	4,515
Subordinated capital notes	534	766	1,236	1,524
Total interest expense	56,723	53,111	113,915	101,222
Net interest income	28,435	17,690	53,344	31,078
Provision for loan losses	1,980	1,375	3,630	2,450
Net interest income after provision for loan losses	26,455	16,315	49,714	28,628
Non-interest income:				
Financial service revenues	4,500	4,049	8,740	8,892
Banking service revenues	1,395	2,265	2,922	4,139
Investment banking revenues	12		750	
Mortgage banking activities	545	170	1,551	232
Net gain (loss) on:				
Sale of securities available-for-sale	198		9,522	358
Derivatives	228	88	(7,575)	8,384
Trading securities	16	2	(1)	2
Other investments	16	1,169	116	788
Foreclosed real estate	(260)	30	(510)	67
Other		23	(1)	65
Total non-interest income, net	6,650	7,796	15,514	22,927

Non-interest expenses:

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Compensation and employee benefits	7,824	6,916	15,539	13,661
Occupancy and equipment	3,365	3,343	6,652	6,337
Professional and service fees	2,267	1,984	4,147	3,522
Advertising and business promotion	836	1,118	1,910	1,911
Directors and investor relations	303	769	581	1,300
Loan servicing expenses	339	540	670	1,063
Taxes, other than payroll and income taxes	607	489	1,218	937
Electronic banking charges	396	457	814	916
Clearing and wrap fees expenses	313	310	607	675
Communication	325	308	650	646
Insurance	579	211	1,181	427
Foreclosure expenses	201	338	351	405
Printing, postage, stationery and supplies	245	189	522	391
Other	480	505	968	1,113
Total non-interest expenses	18,080	17,477	35,810	33,304
Income before income taxes	15,025	6,634	29,418	18,251
Income tax expense (benefit)	598	187	(1,857)	811
Net income	14,427	6,447	31,275	17,440
Less: Dividends on preferred stock	(1,200)	(1,201)	(2,401)	(2,401)
Income available to common shareholders	\$ 13,227	\$ 5,246	\$ 28,874	\$ 15,039
Income per common share:				
Basic	\$ 0.54	\$ 0.21	\$ 1.19	\$ 0.61
Diluted	\$ 0.54	\$ 0.21	\$ 1.19	\$ 0.61
Average common shares outstanding	24,290	24,488	24,227	24,480
Average potential common shares-options	94	75	110	97
Average diluted common shares outstanding	24,384	24,563	24,337	24,577
Cash dividends per share of common stock	\$ 0.14	\$ 0.14	\$ 0.28	\$ 0.28

See notes to unaudited consolidated financial statements.

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FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2008 AND 2007***(In thousands)*

CHANGES IN STOCKHOLDERS EQUITY:	Six-Month Period Ended June	
	2008	30, 2007
Preferred stock:		
Balance at beginning and end of period	\$ 68,000	\$ 68,000
Common stock:		
Balance at beginning of period	25,557	25,431
Stock options exercised	179	112
Balance at end of period	25,736	25,543
Additional paid-in capital:		
Balance at beginning of period	210,073	209,033
Stock-based compensation expense	252	12
Stock options exercised	1,957	815
Balance at end of period	212,282	209,860
Legal surplus:		
Balance at beginning of period	40,573	36,245
Transfer from retained earnings	2,960	2,067
Balance at end of period	43,533	38,312
Retained earnings:		
Balance at beginning of period	45,296	26,772
Net income	31,275	17,440
Cash dividends declared on common stock	(6,804)	(6,861)
Cash dividends declared on preferred stock	(2,401)	(2,401)
Transfer to legal surplus	(2,960)	(2,067)
Balance at end of period	64,406	32,883
Treasury stock:		
Balance at beginning of period	(17,023)	(12,956)
Stock used to match defined contribution plan 1165(e)	121	175
Stock purchased	(234)	(530)

Balance at end of period	(17,136)	(13,311)
Accumulated other comprehensive loss, net of tax:		
Balance at beginning of period	(13,015)	(16,099)
Other comprehensive loss, net of tax	(82,639)	(31,713)
Balance at end of period	(95,654)	(47,812)
Total stockholders equity	\$ 301,167	\$ 313,475

**UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2008 AND 2007**

(In thousands)

COMPREHENSIVE INCOME	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2008	2007	2008	2007
Net income	\$ 14,427	\$ 6,447	\$ 31,275	\$ 17,440
Other comprehensive loss, net of tax:				
Unrealized loss on securities available-for-sale	(51,649)	(31,296)	(79,685)	(26,097)
Realized gain on investment securities available-for-sale included in net income	(198)		(9,522)	(358)
Gains on derivatives designated as cash flow hedges included in net income				(773)
Gain from termination of cash flow hedging				(8,225)
Income tax effect related to unrealized loss on securities available-for-sale	4,156	4,381	6,568	3,740
Other comprehensive loss for the period	(47,691)	(26,915)	(82,639)	(31,713)
Comprehensive loss	\$ (33,264)	\$ (20,468)	\$ (51,364)	\$ (14,273)

See notes to unaudited consolidated financial statements.

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**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2008 AND 2007
(In thousands)**

	Six-Month Period Ended June 30,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 31,275	\$ 17,440
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of deferred loan origination fees, net of costs	(214)	(771)
Amortization of premiums, net of accretion of discounts	31	4,143
Depreciation and amortization of premises and equipment	2,613	2,916
Deferred income tax benefit	(319)	(116)
Equity in earnings of investment in limited liability partnership		(75)
Provision for loan losses	3,630	2,450
Common stock used to match defined contribution plan 1165(e)	121	175
Stock-based compensation	252	12
(Gain) loss on:		
Sale of securities available-for-sale	(9,522)	(358)
Mortgage banking activities	(1,551)	(232)
Derivatives	7,575	(8,898)
Foreclosed real estate	510	(67)
Sale of premises and equipment	1	(20)
Originations and purchases of loans held-for-sale	(74,265)	(80,420)
Proceeds from sale of loans held-for-sale	20,918	25,223
Net decrease (increase) in:		
Trading securities	(189)	(305)
Accrued interest receivable	9,473	(17,867)
Other assets	(11,219)	(4,597)
Net increase (decrease) in:		
Accrued interest on deposits and borrowings	604	(4,216)
Other liabilities	(3,332)	1,015
Net cash used in operating activities	(23,608)	(64,568)
Cash flows from investing activities:		
Net increase in securities purchased under agreements to resell		(16,200)
Purchases of:		
Investment securities available-for-sale	(2,790,964)	(1,053,377)
Investment securities held-to-maturity		(10,772)
Other investments		(701)
Equity options	(1,729)	(9,504)
FHLB stock	(7,089)	(17,162)
Maturities and redemptions of:		
Investment securities available-for-sale	1,396,359	70,857

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Investment securities held-to-maturity	254,978	273,663
Other investments	1,511	
FHLB stock	5,685	16,860
Proceeds from sales of:		
Investment securities available-for-sale	943,134	23,032
Foreclosed real estate	2,466	1,414
Premises and equipment	14	
Loan production:		
Origination and purchase of loans, excluding loans held-for-sale	(84,597)	(85,230)
Principal repayment of loans	63,977	77,719
Additions to premises and equipment	(2,227)	(2,133)
Net cash used in investing activities	(218,482)	(731,534)
Cash flows from financing activities:		
Net increase (decrease) in:		
Deposits	260,671	96,770
Securities sold under agreements to repurchase	(50,023)	750,161
Federal funds purchased and other short term borrowings	14,123	11,073
Proceeds from:		
Advances from FHLB	294,750	2,463,370
Exercise of stock options	2,136	927
Repayments of advances from FHLB	(294,750)	(2,465,270)
Repurchase of treasury stock	(234)	(530)
Maturity of term note		(15,000)
Termination of derivative instrument	(7,875)	
Dividend paid on common and preferred stock	(9,205)	(9,262)
Net cash provided by financing activities	209,593	832,239
Net change in cash and due from banks	(32,497)	36,137
Cash and due from banks at beginning of period	88,983	34,070
Cash and due from banks at end of period	\$ 56,486	\$ 70,207
Supplemental Cash Flow Disclosure and Schedule of Noncash Activities:		
Interest paid	\$ 113,311	\$ 96,790
Income tax paid	\$ 37	\$
Mortgage loans securitized into mortgage-backed securities	\$ 29,836	\$
Securities sold but not yet delivered	\$	\$ 46,461
Securities purchased but not yet received	\$ 23,103	\$ 100,067
Transfer from loans to foreclosed real estate	\$ 3,675	\$ 1,454

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 June 30, 2008, and December 31, 2007, and the consolidated results of operations and cash flows for the quarters and six-month periods ended June 30, 2008 and 2007. 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 six-month periods ended June 30, 2008 and 2007 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, 2007, included in the Group s 2007 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 two special purpose entities, Oriental Financial (PR) Statutory Trust I (the Statutory Trust I , presently inactive) and 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 10 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 24 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, and also through its mortgage lending subsidiary, Oriental Mortgage Corporation. 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

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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.

In January 2008, the Group entered into an exclusive alliance with Primerica Financial Services, Inc., a wholly-owned subsidiary of Citigroup, in which the Group is the supplier of a mortgage platform and related services for Primerica in its program to market home loans to its clients in Puerto Rico.

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-an amendment of FASB Statements No. 5 and 15* (SFAS 114). 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* (SFAS 5), 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.

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.

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SFAS No. 157, *Fair Value Measurements* (SFAS 157), establishes a fair value hierarchy that prioritizes the inputs to 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. For further details regarding the Group's investment securities and fair value measurements, refer to Note 2 and Note 8, respectively, of the unaudited consolidated financial statements.

Impairment of Investment Securities

The Group evaluates its securities available-for-sale and held-to-maturity for impairment. An impairment charge in the unaudited consolidated statements of income is recognized when the decline in the fair value of investments below their cost basis is judged to be other-than-temporary. The Group considers various factors in determining whether it should recognize an impairment charge, including, but not limited to the length of time and extent to which the fair value has been less than its cost basis, and the Group's ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value. For debt securities, the Group also considers, among other factors, the investors repayment ability on its debt obligations and its cash and capital generation ability.

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 Group maintained an effective tax rate lower than the maximum marginal statutory rate of 39% for 2008 and 2007, 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 OIB. 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 income. Management evaluates the realizability of the deferred tax assets on a regular basis and assesses the need for a valuation allowance. Changes in valuation allowance from period to period are included in the Group's tax provision in the period of change. As of June 30, 2008, a valuation allowance of approximately \$1.5 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 certain tax contingencies 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 tax contingency accruals are adjusted in light of changing facts and circumstances,

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such as the progress of tax audits, case law and emerging legislation. The Group's tax contingency accruals are reflected as income tax payable as a component of accrued expenses and other liabilities.

Beginning with the adoption of Financial Accounting Standard Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* , on January 1, 2007, the Group recognized the effect of income tax positions only if those positions are more likely than not of being sustained. Unrecognized tax benefits are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. Prior to the adoption of FIN 48, the Group recognized the effect of income tax positions only if such positions were probable of being sustained.

The total amount of gross unrecognized tax benefits as of the date of adoption that would affect the effective tax rate was \$5.7 million. The Group classifies unrecognized tax benefits in income taxes payable. No adjustments resulted from the implementation of FIN 48. These gross unrecognized tax benefits would affect the effective tax rate if realized. On January 13, 2008, \$2.4 million in unrecognized tax benefits expired due to the statute of limitations. The Group does not anticipate any other significant changes in unrecognized tax benefits during 2008. The balance of unrecognized tax benefits at June 30, 2008 was \$4.0 million (December 31, 2007 – \$5.7 million). The tax periods ended June 30, 2004, and 2005, and December 31, 2005, 2006 and 2007, 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 unaudited consolidated statements of income did not change as a result of implementing the provisions of FIN 48. As of the date of adoption of FIN 48, the Group had accrued \$1.3 million (June 30, 2008-\$1.3 million; December 31, 2007-\$1.9 million) for the payment of interest and penalties relating to unrecognized tax benefits.

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.

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:

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	Six-Month Period Ended	
	June 30,	
	2008	2007
Weighted Average Assumptions:		
Dividend yield	4.40%	4.54%
Expected volatility	31.86%	33.34%
Risk-free interest rate	4.33%	4.65%
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.

Recent Accounting Developments:**FASB Staff Position (FSP) FAS No. 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions.**

In February 2008, the FASB issued FSP FAS No. 140-3, which requires an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously or in contemplation of the initial transfer to be evaluated as a linked transaction under SFAS No. 140 unless certain criteria are met, including that the transferred asset must be readily obtainable in the marketplace. FSP No. 140-3 is effective for fiscal years beginning after November 15, 2008, and will be applied to new transactions entered into after the date of adoption. Early adoption is prohibited. The Group is currently evaluating the impact of adopting FSP No. 140-3 on its financial condition and cash flows. Adoption of FSP No. 140-3 will have no effect on the Group's results of operations.

SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133.

In March 2008, the FASB issued SFAS No. 161, requiring enhanced disclosures about an entity's derivative and hedging activities, and is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early application encouraged. The Group will adopt SFAS No. 161 in the first quarter of 2009. Since SFAS No. 161 requires only additional disclosures concerning derivatives and hedging activities, adoption of SFAS No. 161 will not affect the Group's financial condition, results of operations or cash flows.

FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities.

In June 2008, the FASB issued FSP EITF No. 03-6-1, which addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be included in the earnings allocation in calculating earnings per share under the two-class method described in SFAS No. 128, Earnings per Share. The FSP requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share. The FSP is effective for fiscal years beginning after December 15, 2008; earlier application is not permitted. The Group does not expect adoption of FSP EITF No. 03-6-1 to have a material effect on its results of operations or earnings per share.

NOTE 2 INVESTMENT SECURITIES**Money Market Investments**

The Group considers as cash equivalents all money market instruments that are not pledged and that have maturities of three months or less at the date of acquisition. At June 30, 2008, and December 31, 2007, cash equivalents included as part of cash and due from banks amounted to \$44.9 million and \$66.1 million, respectively.

Investment Securities

The amortized cost, gross unrealized gains and losses, fair value, and weighted average yield of the investment securities as of June 30, 2008, and December 31, 2007, were as follows:

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	June 30, 2008 (In thousands)				Weighted Average Yield
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	
Available-for-sale					
Puerto Rico Government and agency obligations	\$ 16,564	\$ 13	\$ 706	\$ 15,871	5.58%
Obligations of US Government sponsored agencies	750,784	7,013	210	757,587	5.69%
Structured credit investments	85,548		16,440	69,108	4.74%
Total investment securities	852,896	7,026	17,356	842,566	
FNMA and FHLMC certificates	1,518,229	4,729	15,983	1,506,975	5.81%
GNMA certificates	49,385	684	260	49,809	5.68%
Non-agency collateralized mortgage obligations (CMOs)	710,041		53,374	656,667	5.61%
CMOs issued by US Government sponsored agencies	336,454	14	10,178	326,290	5.37%
Total mortgage-backed-securities and CMOs	2,614,109	5,427	79,795	2,539,741	
Total securities available-for-sale	3,467,005	12,453	97,151	3,382,307	5.67%
Held-to-maturity					
Puerto Rico Government and agency obligations	55,164		3,745	51,419	5.29%
Obligations of US Government sponsored agencies	224,860	1,497		226,357	4.78%
Structured credit investments	96,171		29,682	66,489	4.48%
Total investment securities	376,195	1,497	33,427	344,265	
FNMA and FHLMC certificates	583,107	83	7,544	575,646	5.06%
GNMA certificates	152,260	115	1,715	150,660	5.37%
CMOs issued by US Government sponsored agencies	126,585	1,917	337	128,165	5.15%
Total mortgage-backed-securities and CMOs	861,952	2,115	9,596	854,471	

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Total securities held-to-maturity	1,238,147	3,612	43,023	1,198,736	5.02%
Total	\$ 4,705,152	\$ 16,065	\$ 140,174	\$ 4,581,043	5.50%

	December 31, 2007 (In thousands)				Weighted
	Amortized	Gross	Gross	Fair	Average
	Cost	Unrealized	Unrealized	Value	Yield
Available-for-sale					
Puerto Rico Government and agency obligations	\$ 18,331	\$ 63	\$ 937	\$ 17,457	5.69%
Obligations of US Government sponsored agencies	1,279,977	14,933		1,294,910	5.91%
Structured credit investments	85,548		7,188	78,360	5.46%
Total investment securities	1,383,856	14,996	8,125	1,390,727	
FNMA and FHLMC certificates	998,008	10,681	223	1,008,466	5.85%
GNMA certificates	48,907	869	216	49,560	5.69%
Non-agency collateralized mortgage obligations (CMOs)	632,992	42	12,505	620,529	5.49%
Total mortgage-backed-securities and CMOs	1,679,907	11,592	12,944	1,678,555	
Total securities available-for-sale	3,063,763	26,588	21,069	3,069,282	5.78%
Held-to-maturity					
Puerto Rico Government and agency obligations	55,206		3,781	51,425	5.29%
Obligations of US Government sponsored agencies	418,731	902	1,980	417,653	4.92%
Structured credit investments	96,171		11,949	84,222	6.69%
Total investment securities	570,108	902	17,710	553,300	
FNMA and FHLMC certificates	624,267	4,331	3,560	625,038	5.03%
GNMA certificates	161,647	1,504	1,204	161,947	5.36%
CMOs issued by US Government sponsored agencies	136,865	1,489	527	137,827	5.14%
Total mortgage-backed-securities and CMOs	922,779	7,324	5,291	924,812	

Total securities held-to-maturity	1,492,887	8,226	23,001	1,478,112	5.16%
Total	\$ 4,556,650	\$ 34,814	\$ 44,070	\$ 4,547,394	5.58%

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The amortized cost and fair value of the Group's investment securities available-for-sale and held-to-maturity at June 30, 2008, 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.

	<i>(In thousands)</i>			
	Available-for-sale		Held-to-maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Investment securities				
Due within 1 year	\$ 1,499	\$ 1,499	\$	\$
Due after 1 to 5 years			125,000	126,355
Due after 5 to 10 years	347,738	337,210	60,000	41,775
Due after 10 years	503,659	503,857	191,195	176,135
	852,896	842,566	376,195	344,265
Mortgage-backed securities				
Due within 1 year	27	27		
Due after 1 to 5 years	660	688		
Due after 5 to 10 years			58,425	56,442
Due after 10 years	2,613,422	2,539,026	803,527	798,029
	2,614,109	2,539,741	861,952	854,471
	\$3,467,005	\$3,382,307	\$1,238,147	\$1,198,736

In keeping with the Group's investment strategy, during the six-month periods ended June 30, 2008 and 2007, 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. Proceeds from the sale of investment securities available-for-sale during the six-month periods ended June 30, 2008 and 2007, totaled \$943.1 million and \$23.0 million, respectively. Realized gains on those sales during the six-month periods ended June 30, 2008 and 2007, were \$9.5 million and \$358,000, respectively. There were no realized losses on those sales during the six-month periods ended June 30, 2008 and 2007.

The table below presents an analysis of the gross realized gains and losses by category for the six-month periods ended June 30, 2008 and 2007:

Six-month period ended June 30, 2008*In thousands*

Description	Original Face	Original Cost	Sale Proceeds	Sale Book		
				Value	Gains	Losses

Gain on Sale of Securities**Available-for-Sale****Investment securities**

Puerto Rico Government and agency obligations	\$ 1,830	\$ 1,843	\$ 1,862	\$ 1,804	\$ 58	\$
Obligations of U.S. Government sponsored agencies	709,300	708,957	718,291	709,070	9,221	
Total investment securities	711,130	710,800	720,153	710,874	9,279	

Mortgage-backed securities and CMOs

FNMA and FHLMC certificates	250,287	250,506	198,348	198,229	119	
GNMA certificates	24,958	26,440	24,633	24,509	124	

Total mortgage-backed securities and CMOs

	275,245	276,946	222,981	222,738	243	
	\$986,375	\$987,746	\$943,134	\$933,612	\$9,522	\$

Table of Contents**Six-month period ended June 30, 2007***In thousands*

Description	Original Face	Original Cost	Sale Proceeds	Sale Book Value	Gains	Losses
Gain on sale of securities available-for-sale						
Investment securities						
Corporate bonds and other	\$25,000	\$ 24,909	\$23,032	\$22,674	\$358	\$
	\$25,000	\$ 24,909	\$23,032	\$22,674	\$358	\$

The following table shows the Group's gross unrealized losses and fair value of investment securities available-for-sale and held-to-maturity, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2008, and December 31, 2007.

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Table of Contents**June 30, 2008****Available-for-sale***(In thousands)*

	Less than 12 months		
	Amortized Cost	Unrealized Loss	Fair Value
Obligations of U.S. government entities	\$ 19,285	\$ 210	\$ 19,075
Mortgage-backed securities and CMOs	1,339,361	30,260	1,309,101
Structured credit investments	60,000	14,100	45,900
	1,418,646	44,570	1,374,076
	12 months or more		
	Amortized Cost	Unrealized Loss	Fair Value
Puerto Rico government and agency obligations	16,184	706	15,478
Mortgage-backed securities and CMOs	592,327	49,535	542,792
Structured credit investments	25,548	2,340	23,208
	634,059	52,581	581,478
	Amortized Cost	Total Unrealized Loss	Fair Value
Obligations of U.S. government entities	19,285	210	19,075
Puerto Rico government and agency obligations	16,184	706	15,478
Mortgage-backed securities and CMOs	1,931,688	79,795	1,851,893
Structured credit investments	85,548	16,440	69,108
	\$ 2,052,705	\$ 97,151	\$ 1,955,554

Held-to-maturity*(In thousands)*

	Less than 12 months		
	Amortized Cost	Unrealized Loss	Fair Value
Mortgage-backed securities and CMOs	\$ 636,823	\$ 6,470	\$ 630,353
Structured credit investments	96,171	29,682	66,489
	732,994	36,152	696,842

	12 months or more		
	Amortized Cost	Unrealized Loss	Fair Value
Puerto Rico government and agency obligations	55,164	3,745	51,419
Mortgage-backed securities and CMOs	83,618	3,126	80,492
	138,782	6,871	131,911
	Amortized Cost	Total Unrealized Loss	Fair Value
Puerto Rico government and agency obligations	55,164	3,745	51,419
Mortgage-backed securities and CMOs	720,441	9,596	710,845
Structured credit investments	96,171	29,682	66,489
	\$ 871,776	\$ 43,023	\$ 828,753

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Table of Contents**December 31, 2007****Available-for-sale***(In thousands)*

	Less than 12 months		
	Amortized Cost	Unrealized Loss	Fair Value
Puerto Rico Government and agency obligations	\$ 1,996	\$ 325	\$ 1,671
Mortgage-backed-securities and CMOs	118,616	336	118,280
Structured credit investments	85,548	7,188	78,360
	206,160	7,849	198,311
	12 months or more		
	Amortized Cost	Unrealized Loss	Fair Value
Puerto Rico Government and agency obligations	14,152	612	13,540
Mortgage-backed-securities and CMOs	634,910	12,608	622,302
	649,062	13,220	635,842
	Amortized Cost	Total Unrealized Loss	Fair Value
Puerto Rico Government and agency obligations	16,148	937	15,211
Mortgage-backed-securities and CMOs	753,526	12,944	740,582
Structured credit investments	85,548	7,188	78,360
	\$ 855,222	\$ 21,069	\$ 834,153

Held-to-maturity*(In thousands)*

	Less than 12 months		
	Amortized Cost	Unrealized Loss	Fair Value
Puerto Rico Government and agency obligations	\$ 4,238	\$ 54	\$ 4,184
Mortgage-backed-securities and CMOs	18,403	129	18,274
Structured credit investments	96,171	11,949	84,222

	118,812	12,132	106,680
	Amortized Cost	12 months or more Unrealized Loss	Fair Value
Obligations of US Government sponsored agencies	124,998	1,980	123,018
Puerto Rico Government and agency obligations	50,968	3,727	47,241
Mortgage-backed-securities and CMOs	373,122	5,162	367,960
	549,088	10,869	538,219
	Amortized Cost	Total Unrealized Loss	Fair Value
Obligations of US Government sponsored agencies	124,998	1,980	123,018
Puerto Rico Government and agency obligations	55,206	3,781	51,425
Mortgage-backed-securities and CMOs	391,525	5,291	386,234
Structured credit investments	96,171	11,949	84,222
	\$ 667,900	\$ 23,001	\$ 644,899

At June 30, 2008, mortgage-backed securities include approximately \$710.0 million in non-agency collateralized mortgage obligations with unrealized losses of \$53.4 million in the Group's available-for-sale investment securities portfolio. These obligations are collateralized by pools of mortgage loans originated in the U.S., and are senior classes having subordination of losses ranging from 4.7% to 16.6%, which provide the capacity to absorb estimated collateral losses. These issues, including one that is backed by Alternative-A (Alt-A) loan collateral originated in 2006, are rated AAA by Standard & Poor's and Aaa by Moody's.

At June 30, 2008, the investment securities portfolio includes structured credit investments issued by U.S. institutions with balances of \$85.5 million in the available-for-sale portfolio, and \$96.2 million in the held-to-maturity portfolio, with unrealized losses of approximately \$16.4 million and \$29.7 million, respectively. The unrealized loss position is a reflection of the credit markets' recent activity, with credit spreads widening significantly. The underlying collateral on the structures that the Group owns has performed adequately, with no defaults to date, and none of the structured credit investments has been downgraded.

All other securities in an unrealized loss position at June 30, 2008, 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

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of such other securities at June 30, 2008, are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuer.

At June 30, 2008, management 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. The Group is closely monitoring these securities for any decline in value that the Group's management may consider to be other-than-temporary.

NOTE 3 LOANS 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 June 30, 2008, and December 31, 2007, was as follows:

	<i>(In thousands)</i>	
	June 30, 2008	December 31, 2007
Loans secured by real estate:		
Residential mortgage loans	\$ 968,875	\$ 960,704
Home equity loans, secured personal loans and others	26,210	28,783
Commercial	153,509	135,070
Deferred loan fees, net	(3,320)	(2,887)
	1,145,274	1,121,670
Other loans:		
Commercial	17,335	22,128
Personal consumer loans and credit lines	25,479	29,245
Deferred loan (fees) cost, net	(168)	12
	42,646	51,385
Loans receivable	1,187,920	1,173,055
Allowance for loan losses	(11,885)	(10,161)
Loans receivable, net	1,176,035	1,162,894
Mortgage loans held-for-sale	42,122	16,672
Total loans, net	\$ 1,218,157	\$ 1,179,566

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 and six-month periods ended June 30, 2008 and 2007.

The Group evaluates all loans, some individually, and others as homogeneous groups, for purposes of determining impairment. At June 30, 2008, and December 31, 2007, the total balance of impaired loans was \$1.6 million and \$1.1 million, respectively. The impaired loans were measured based on the fair value of collateral. The Group's management determined that impaired loans did not require a valuation allowance in accordance with SFAS 114.

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Table of Contents**NOTE 4 PLEDGED ASSETS**

At June 30, 2008, residential mortgage loans amounting to \$500.0 million were pledged to secure advances and borrowings from the FHLB. Investment securities with fair values totaling \$4.133 billion, \$130.2 million, and \$113.0 million at June 30, 2008, were pledged to secure securities sold under agreements to repurchase, public fund deposits and other funds, respectively. Also, investment securities with fair value totaling \$120,000 at June 30, 2008, were pledged to the Puerto Rico Treasury Department.

As of June 30, 2008, investment securities available-for-sale and held-to-maturity not pledged amounted to \$168.9 million and \$76.4 million, respectively. As of June 30, 2008, mortgage loans not pledged amounted to \$533.8 million.

NOTE 5 OTHER ASSETS

Other assets at June 30, 2008, and December 31, 2007 include the following:

	<i>(In thousands)</i>	
	June 30, 2008	December 31, 2007
Prepaid expenses	\$ 5,004	\$ 2,645
Mortgage tax credits	4,992	69
Servicing asset	2,934	2,526
Goodwill	2,006	2,006
Investment in Statutory Trust	1,086	1,086
Deferred charges	893	910
Accounts receivable and other assets	10,628	7,082
	\$ 27,543	\$ 16,324

Mortgage tax credits in the table above, are related to the approval on December 14, 2007, of the Act Number 97 (the Act) to stimulate the economy and private investment by stimulating the real estate industry, in particular the sale of housing. Under the terms of the Act certain home mortgage loans qualify for a government credit of up to \$25,000. The Group disburses 100% of the residence purchase price not covered by down payment and records a loan for the amount disbursed less the government credit. The government credit is recorded as a mortgage tax credit, which can be used as a reduction of the Group's income tax liability commencing with calendar year 2008. Mortgage tax credits are transferable.

NOTE 6 BORROWINGS***Short Term Borrowings***

At June 30, 2008, short term borrowings amounted to \$41.6 million (December 31, 2007 \$27.5 million) which mainly consist of federal funds purchased with a weighted average rate of 1.75% (December 31, 2007 1.83%).

Securities Sold under Agreements to Repurchase

At June 30, 2008, 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.

Securities sold under agreements to repurchase, excluding accrued interest in the amount of \$10.8 million at June 30, 2008, mature as follows:

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	<i>(In thousands)</i>
	Balance
Short-term repurchase agreements	
Due within 30 days	\$ 50,000
Structured repurchase agreements	
Due after 1 to 3 years	100,000
Due after 3 to 5 years	1,800,000
Due after 5 to 10 years	1,850,000
Sub-total structured repurchase agreements	3,750,000
Total repurchase agreements	\$ 3,800,000

During the fourth quarter of 2006 and throughout 2007, the Group restructured most of its short-term repurchase agreements portfolio into longer-term, structured repurchase agreements. The terms of these structured positions range between three and ten years, and the counterparties 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 at June 30, 2008:

(In thousands)

Borrowing Balance	Weighted- Average Coupon	Settlement Date	Maturity Date	Next Put Date
\$ 450,000	4.34%	12/28/2006	12/28/2011	12/28/2008
450,000	4.22%	12/28/2006	12/28/2011	9/28/2008
250,000	4.44%	3/02/2007	3/02/2017	3/2/2009
500,000	4.46%	3/02/2007	3/02/2017	3/2/2009
150,000	4.31%	3/06/2007	12/06/2012	12/7/2009
900,000	3.71%	3/06/2007	3/06/2017	3/6/2009
350,000	4.26%	5/09/2007	5/09/2012	8/9/2008
100,000	3.71%	3/06/2007	3/06/2017	3/6/2009
100,000	4.67%	7/27/2007	7/27/2014	1/27/2010
100,000	4.39%	8/14/2007	8/16/2010	8/14/2008
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
\$ 3,750,000	4.19%			

Advances from the Federal Home Loan Bank

At June 30, 2008, the advances from the FHLB, excluding accrued interest in the amount of \$1.9 million, mature as follows:

	<i>(In thousands)</i>
	Balance
Short-term FHLB advances	

Due after 60 to 90 days	\$	50,000
Structured FHLB advances		
Due after 3 to 5 years		225,000
Due after 5 to 10 years		55,000