

ORIENTAL FINANCIAL GROUP INC

Form 10-Q

May 10, 2007

Table of Contents

**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 March 31, 2007

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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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:

24,500,842 common shares (\$1.00 par value per share)

outstanding as of April 30, 2007

Table of Contents

TABLE OF CONTENTS

| | Page |
|--|-------------|
| <u>Part I FINANCIAL INFORMATION:</u> | |
| <u>Item 1 Financial Statements</u> | |
| <u>Unaudited consolidated statements of financial condition at March 31, 2007 and 2006</u> | 1 |
| <u>Unaudited consolidated statements of income for the quarters ended March 31, 2007 and 2006</u> | 2 |
| <u>Unaudited consolidated statements of changes in stockholders' equity for the quarters ended March 31, 2007 and 2006</u> | 3 |
| <u>Unaudited consolidated statements of comprehensive income for the quarters ended March 31, 2007 and 2006</u> | 3 |
| <u>Unaudited consolidated statements of cash flows for the quarters ended March 31, 2007 and 2006</u> | 4 |
| <u>Notes to unaudited consolidated financial statements</u> | 5 |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 18 |
| <u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u> | 33 |
| <u>Item 4 Controls and Procedures</u> | 36 |
| <u>PART II OTHER INFORMATION:</u> | |
| <u>Item 1 Legal Proceedings</u> | 36 |
| <u>Item 1A Risk Factors</u> | 37 |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u> | 37 |
| <u>Item 3 Defaults Upon Senior Securities</u> | 37 |
| <u>Item 4 Submissions of Matters to a Vote of Security Holders</u> | 37 |
| <u>Item 5 Other Information</u> | 37 |
| <u>Item 6 Exhibits</u> | 37 |
| <u>Signatures</u> | 38 |
| <u>Certifications</u> | 39 |
| <u>EX-31.1 SECTION 302 CERTIFICATION OF THE CEO</u> | |
| <u>EX-31.2 SECTION 302 CERTIFICATION OF THE CFO</u> | |
| <u>EX-32.1 SECTION 906 CERTIFICATION OF THE CEO</u> | |
| <u>EX-32.2 SECTION 906 CERTIFICATION OF THE CFO</u> | |

Table of Contents

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
MARCH 31, 2007 AND DECEMBER 31, 2006
(In thousands, except per share data)

| | March 31, 2007 | December 31, 2006 |
|--|---------------------------|----------------------------------|
| ASSETS | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 14,286 | \$ 15,341 |
| Money market investments | 50,127 | 18,729 |
| Total cash and cash equivalents | 64,413 | 34,070 |
| Investments: | | |
| Time deposits with other banks | 5,000 | 5,000 |
| Trading securities, at fair value with amortized cost of \$463 (December 31, 2006 \$246) | 461 | 243 |
| Investment securities available-for-sale, at fair value with amortized cost of \$1,828,459 (December 31, 2006 \$984,060) | | |
| Securities pledged that can be repledged | 1,805,124 | 947,880 |
| Other investment securities | 20,818 | 27,080 |
| Total investment securities available-for-sale | 1,825,942 | 974,960 |
| Investment securities held-to-maturity, at amortized cost with fair value of \$1,880,479 (December 31, 2006 \$1,931,720) | | |
| Securities pledged that can be repledged | 1,810,909 | 1,814,746 |
| Other investment securities | 92,798 | 152,731 |
| Total investment securities held-to-maturity | 1,903,707 | 1,967,477 |
| Other Intestments | 31,578 | 30,949 |
| Federal Home Loan Bank (FHLB) stock, at cost | 14,197 | 13,607 |
| Total investments | 3,780,885 | 2,992,236 |
| Securities sold but not yet delivered | 74,289 | 6,430 |
| Loans: | | |
| Mortgage loans held-for-sale, at lower of cost or market | 42,204 | 10,603 |
| Loans receivable, net of allowance for loan losses of \$8,046 (December 31, 2006 \$8,016) | 1,191,690 | 1,201,767 |

| | | |
|-----------------------------|--------------|--------------|
| Total loans, net | 1,233,894 | 1,212,370 |
| Accrued interest receivable | 30,482 | 27,940 |
| Premises and equipment, net | 19,853 | 20,153 |
| Deferred tax asset, net | 13,562 | 14,150 |
| Foreclosed real estate | 5,320 | 4,864 |
| Other assets | 69,355 | 61,477 |
| Total assets | \$ 5,292,053 | \$ 4,373,690 |

LIABILITIES AND STOCKHOLDERS EQUITY

| | | |
|---|------------|------------|
| Deposits: | | |
| Demand deposits | \$ 124,610 | \$ 132,434 |
| Savings accounts | 307,319 | 266,184 |
| Certificates of deposit | 905,656 | 834,370 |
| Total deposits | 1,337,585 | 1,232,988 |
| Borrowings: | | |
| Federal funds purchased and other short term borrowings | 3,139 | 13,568 |
| Securities sold under agreements to repurchase | 3,321,105 | 2,535,923 |
| Advances from FHLB | 195,000 | 181,900 |
| Term notes | | 15,000 |
| Subordinated capital notes | 36,083 | 36,083 |
| Total borrowings | 3,555,327 | 2,782,474 |
| Securities purchased but not yet received | 40,067 | |
| Accrued expenses and other liabilities | 20,752 | 21,802 |
| Total liabilities | 4,953,731 | 4,037,264 |

Commitments and Contingencies

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; 25,461,200 shares issued (December 31, 2006 25,430,929 shares) | 25,461 | 25,431 |
| Additional paid-in capital | 209,226 | 209,033 |
| Legal surplus | 37,424 | 36,245 |
| Retained earnings | 31,956 | 26,772 |
| Treasury stock, at cost 977,600 shares (December 31, 2006 989,405 shares) | (12,848) | (12,956) |
| Accumulated other comprehensive loss, net of tax of \$351 (December 31, 2006 \$290) | (20,897) | (16,099) |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Total stockholders' equity | 338,322 | 336,426 |
| Total liabilities and stockholders' equity | \$ 5,292,053 | \$ 4,373,690 |

See notes to unaudited consolidated financial statements.

-1-

Table of Contents**UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006***(In thousands, except per share data)*

| | Quarter Ended March 31, | |
|--|--------------------------------|---------------|
| | 2007 | 2006 |
| Interest income: | | |
| Loans | \$ 21,849 | \$ 16,253 |
| Mortgage-backed securities | 25,498 | 24,500 |
| Investment securities | 13,697 | 14,500 |
| Short term investments | 456 | 739 |
| Total interest income | 61,500 | 55,992 |
| Interest expense: | | |
| Deposits | 12,370 | 10,498 |
| Securities sold under agreements to repurchase | 32,789 | 26,363 |
| Advances from FHLB, term notes and other borrowings | 2,317 | 2,622 |
| Subordinated capital notes | 758 | 1,297 |
| Total interest expense | 48,234 | 40,780 |
| Net interest income | 13,266 | 15,212 |
| Provision for loan losses | 1,075 | 1,101 |
| Net interest income after provision for loan losses | 12,191 | 14,111 |
| Non-interest income: | | |
| Financial service revenues | 4,843 | 3,252 |
| Banking service revenues | 1,874 | 2,176 |
| Investment banking revenues | | 1,709 |
| Net gain on: | | |
| Mortgage banking activities | 62 | 436 |
| Securities available-for-sale | 358 | 19 |
| Derivatives | 8,418 | 882 |
| Trading securities | | 28 |
| Other | (304) | 451 |
| Total non-interest income, net | 15,251 | 8,953 |
| Non-interest expenses: | | |
| Compensation and employee s benefits | 6,745 | 6,173 |
| Occupancy and equipment | 2,994 | 2,889 |
| Advertising and business promotion | 793 | 937 |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Directors and investor relations | 531 | 144 |
| Professional and service fees | 1,538 | 1,624 |
| Communication | 338 | 447 |
| Loan servicing expenses | 523 | 455 |
| Taxes, other than payroll and income taxes | 448 | 600 |
| Electronic banking charges | 458 | 468 |
| Printing, postage, stationery and supplies | 202 | 186 |
| Insurance | 216 | 213 |
| Other | 1,041 | 747 |
| Total non-interest expenses | 15,827 | 14,883 |
| Income before income taxes | 11,615 | 8,181 |
| Income tax expense | 624 | 131 |
| Net income | 10,991 | 8,050 |
| Less: Dividends on preferred stock | (1,200) | (1,200) |
| Income available to common shareholders | \$ 9,791 | \$ 6,850 |
| Income per common share: | | |
| Basic | \$ 0.40 | \$ 0.28 |
| Diluted | \$ 0.40 | \$ 0.28 |
| Average common shares outstanding | 24,472 | 24,613 |
| Average potential common shares-options | 93 | 137 |
| | 24,565 | 24,750 |
| Cash dividends per share of common stock | \$ 0.14 | \$ 0.14 |

See notes to unaudited consolidated financial statements.

-2-

Table of Contents

**UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006
(In thousands)**

| | Quarter Ended March 31, | |
|---|--------------------------------|------------------|
| | 2007 | 2006 |
| CHANGES IN STOCKHOLDERS' EQUITY: | | |
| Preferred stock: | | |
| Balance at beginning and end of period | \$ 68,000 | \$ 68,000 |
| Common stock: | | |
| Balance at beginning of period | 25,431 | 25,350 |
| Stock options exercised | 30 | 15 |
| Balance at end of period | 25,461 | 25,365 |
| Additional paid-in capital: | | |
| Balance at beginning of period | 209,033 | 208,454 |
| Stock-based compensation expense | 4 | 6 |
| Stock options exercised | 189 | 121 |
| Balance at end of period | 209,226 | 208,581 |
| Legal surplus: | | |
| Balance at beginning of period | 36,245 | 35,863 |
| Transfer from retained earnings | 1,179 | 917 |
| Balance at end of period | 37,424 | 36,780 |
| Retained earnings: | | |
| Balance at beginning of period | 26,772 | 52,340 |
| Net income | 10,991 | 8,050 |
| Cash dividends declared on common stock | (3,428) | (3,448) |
| Cash dividends declared on preferred stock | (1,200) | (1,200) |
| Transfer to legal surplus | (1,179) | (917) |
| Balance at end of period | 31,956 | 54,825 |
| Treasury stock: | | |
| Balance at beginning of period | (12,956) | (10,332) |
| Stock used to match defined contribution plan 1165(e) | 108 | 92 |

| | | |
|--|-------------------|-------------------|
| Balance at end of period | (12,848) | (10,240) |
| Accumulated other comprehensive loss, net of tax: | | |
| Balance at beginning of period | (16,099) | (37,884) |
| Other comprehensive loss, net of tax | (4,798) | (1,817) |
| Balance at end of period | (20,897) | (39,701) |
| Total stockholders equity | \$ 338,322 | \$ 343,610 |

**UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006
(In thousands)**

| | Quarter Ended March 31, | |
|--|------------------------------------|-----------------|
| | 2007 | 2006 |
| COMPREHENSIVE INCOME | | |
| Net income | \$ 10,991 | \$ 8,050 |
| Other comprehensive income (loss), net of tax: | | |
| Unrealized gain (loss) on securities available-for-sale | 4,841 | (11,543) |
| Realized gain on investment securities available-for-sale included in net income | | (19) |
| Unrealized gain on derivatives designated as cash flows hedges arising during the period | | 9,916 |
| Gains on derivatives designated as cash flow hedges included in net income | (773) | (749) |
| Gain from termination of cash flow hedging | (8,225) | |
| Income tax effect related to unrealized (gain) loss on securities available-for-sale | (641) | 578 |
| Other comprehensive loss for the period | (4,798) | (1,817) |
| Comprehensive income | \$ 6,193 | \$ 6,233 |

See notes to unaudited consolidated financial statements

Table of Contents

**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006
(In thousands)**

| | Quarter ended March 31, | |
|---|--------------------------------|-------------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 10,991 | \$ 8,050 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Amortization of deferred loan origination fees, net of costs | (285) | (401) |
| Amortization of premiums, net of accretion of discounts | 986 | (359) |
| Depreciation and amortization of premises and equipment | 1,393 | 1,567 |
| Deferred income tax benefit | (53) | (1,045) |
| Equity in losses (earnings) of investment in limited liability partnership | 892 | (304) |
| Provision for loan losses | 1,075 | 1,001 |
| Common stock used to match defined contribution plan 1165(e) | 108 | 92 |
| Stock-based compensation | 4 | 6 |
| Gain on: | | |
| Sale of securities available-for-sale | (358) | (19) |
| Mortgage banking activities | (62) | (436) |
| Derivatives | (9,052) | (882) |
| Sale of foreclosed real estate | (37) | (104) |
| Originations of loans held-for-sale | (36,766) | (13,243) |
| Proceeds from sale of loans held-for-sale | 5,227 | 6,656 |
| Net decrease (increase) in: | | |
| Trading securities | (218) | (174) |
| Accrued interest receivable | (2,542) | (472) |
| Other assets | (3,239) | 152 |
| Net decrease in: | | |
| Accrued interest on deposits and borrowings | (2,683) | (153) |
| Other liabilities | (636) | (175) |
| Net cash used in operating activities | (35,255) | (243) |
| Cash flows from investing activities: | | |
| Purchases of: | | |
| Investment securities available-for-sale | (900,000) | (101,616) |
| Other Investments | (31) | |
| Equity options | (5,764) | |
| Maturities and redemptions of: | | |
| Investment securities available-for-sale | 30,160 | 37,616 |
| Investment securities held-to-maturity | 63,663 | 39,371 |
| FHLB stock | (590) | 599 |
| Proceeds from sales of: | | |
| Investment securities available-for-sale | 23,031 | 15,193 |
| Foreclosed real estate | 820 | 1,218 |
| Loan production: | | |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | |
|---|-------------|-----------|
| Origination and purchase of loans, excluding loans held-for-sale | (35,515) | (79,416) |
| Principal repayment of loans | 43,563 | 44,347 |
| Additions to premises and equipment | (1,093) | (2,046) |
| Net cash used in investing activities | (781,756) | (44,734) |
| Cash flows from financing activities: | | |
| Net increase (decrease) in: | | |
| Deposits | 104,304 | (25,715) |
| Securities sold under agreements to repurchase | 759,788 | 85,391 |
| Federal funds purchased | (10,429) | 499,593 |
| Proceeds from: | | |
| Short term borrowings | | (490,237) |
| Advances from FHLB | 1,121,320 | 515,195 |
| Exercise of stock options | 219 | 136 |
| Repayments of advances from FHLB | (1,108,220) | (528,495) |
| Maturity of term note | (15,000) | |
| Dividend paid in common and preferred stock | (4,628) | (4,645) |
| Net cash provided by financing activities | 847,354 | 51,223 |
| Net change in cash and cash equivalents | 30,343 | 6,246 |
| Cash and cash equivalents at beginning of period | 34,070 | 17,269 |
| Cash and cash equivalents at end of period | \$ 64,413 | \$ 23,515 |
| Supplemental Cash Flow Disclosure and Schedule of Noncash Activities: | | |
| Interest paid | \$ 45,828 | \$ 40,627 |
| Mortgage loans securitized into mortgage-backed securities | \$ | \$ 2,936 |
| Securities sold but not yet delivered | \$ 74,289 | \$ 1,192 |
| Securities and loans purchased but not yet received | \$ 40,067 | \$ 1,233 |
| Transfer from loans to foreclosed real estate | \$ 1,239 | \$ 624 |

See notes to unaudited consolidated financial statements.

-4-

Table of Contents**ORIENTAL FINANCIAL GROUP INC.****Notes to Unaudited Consolidated Financial Statements****NOTE 1 BASIS OF PRESENTATION:**

The accounting and reporting policies of Oriental Financial Group Inc. (the Group or Oriental) conform with U.S. generally accepted accounting principles (GAAP) and to 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 financial condition as of March 31, 2007 and December 31, 2006, and the results of operations, and the cash flows for the quarters ended March 31, 2007 and 2006. 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 quarters ended March 31, 2007 and 2006 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, 2006, included in the Group s Form 10-K.

Nature of Operations

Oriental is a diversified, publicly-owned financial holding company incorporated under the laws of the Commonwealth of Puerto Rico. It has four wholly-owned subsidiaries, Oriental Bank and Trust (the Bank), Oriental Financial Services Corp. (Oriental Financial Services), Oriental Insurance, Inc. (Oriental Insurance), and Caribbean Pension Consultants, Inc. (located in Boca Raton, Florida). The Group also has two special purpose entities, Oriental Financial (PR) Statutory Trust I (the Statutory Trust I) 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 9 to the unaudited consolidated financial statements present 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 twenty-five branches 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 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. The Bank also operates two international banking entities (IBEs) pursuant to the International Banking Center Regulatory Act of Puerto Rico, as amended (the IBE Act): O.B.T. International Bank, which is a unit of the Bank, and Oriental International Bank Inc., which is a wholly-owned subsidiary of the Bank. On January 1, 2004, the Group transferred most of the assets and liabilities of O.B.T. International Bank to Oriental International Bank Inc. The IBE offers the Bank certain Puerto Rico tax advantages and its services 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 National Association of Securities Dealers, Inc., the SEC, and the Office of the Commissioner of Financial Institutions of Puerto Rico.

Oriental Insurance is subject to the supervision, examination and regulation of the Office of the Commissioner of Insurance of 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.

-5-

Table of Contents***Allowance for Loan Losses***

The allowance for loan losses is established through a provision for loan losses based on losses that are estimated to occur. Loan losses are charged against the allowance when the uncollectibility of a loan balance is confirmed.

Subsequent recoveries, if any, are credited to the allowance.

The Group follows a systematic methodology to establish and evaluate the adequacy of the allowance for loan losses. This methodology consists of several key elements. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. 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 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. 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, hedged items, 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 other gains and losses 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.

Impairment of Investment Securities

The Group evaluates its securities available-for-sale and held-to-maturity for impairment. An impairment charge in the 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 consolidated financial statements, the Group is required to estimate income taxes. This involves an estimate of current income tax expense together with an assessment of temporary differences resulting from differences

Table of Contents

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. The Group's effective tax rate includes the impact of unrecognized tax benefits and changes to such benefits, as considered appropriate by management. 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% and 43.5% as of March 31, 2007 and 2006, 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 entities.

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. 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, 2007, a valuation allowance of approximately \$3.9 million was recorded to offset deferred tax assets from loss carry forwards that the Group considers it may not realize in future periods.

Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the projections of future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Group will realize the benefits of these deductible differences, net of the existing valuation allowances at March 31, 2007. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carry forward period are reduced.

Effective at the beginning of the first quarter of 2007, the Group adopted the provision of Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, Accounting for Income Taxes. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely 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 \$5.7 million. The Group historically classified unrecognized tax benefits in current taxes payable. No adjustments resulted by the implementation of FIN 48. These gross unrecognized tax benefits would affect the effective tax rate if realized.

The Group's policy to include interest and penalties related to unrecognized tax benefits within the provision for taxes on the consolidated condensed 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 for the payment of interest and penalties relating to unrecognized tax benefits. The Group does not anticipate significant changes in unrecognized tax benefits

during 2007.

Stock Option Plans

At March 31, 2007, the Group had two stock-based employee compensation plans: the 1998 and 2000 Incentive Stock Option Plans. These plans offer key officers, directors and employees an opportunity to purchase shares of the Group's common stock. The Compensation Committee of the Board of Directors has sole authority and absolute discretion as to the number of stock options to be granted to any officer, director or employee, their vesting rights, and the options exercise

-7-

Table of Contents

prices. The plans provide for a proportionate adjustment in the exercise price and the number of shares that can be purchased in case of merger, consolidation, combination, exchange of shares, other reorganization, recapitalization, reclassification, stock dividend, stock split or reverse stock split in which the number of shares of common stock of the Group as a whole are increased, decreased, changed into or exchanged for a different number or kind of shares or securities. Stock options vest upon completion of specified years of service.

Effective July 1, 2005, the Group adopted SFAS No. 123R Share-Based Payment (SFAS 123R), an amendment of SFAS 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 123R is effective for financial statements as of the beginning of the first interim or annual reporting period of the first fiscal year that began after June 15, 2005. SFAS No. 123R applies to all awards unvested and granted after this effective date and awards modified, repurchased, or cancelled after that date.

The Group recorded approximately \$4,000 during the quarter ended March 31, 2007 related to compensation expense for options issued subsequent to the adoption of SFAS 123R. The remaining unrecognized compensation cost related to unvested awards as of March 31, 2007, was approximately \$303,000 and the weighted average period of time over which this cost will be recognized is approximately 7 years.

The average fair value of each option granted during the quarter ended March 31, 2007 and 2006 was \$3.55 and \$4.05, respectively. The average fair value of each option granted was estimated at the date of the grant using the Black-Scholes option pricing model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no restrictions and are fully transferable and negotiable in a free trading market. Black-Scholes does not consider the employment, transfer or vesting restrictions that are inherent in the Group's employee options. Use of an option valuation model, as required by GAAP, includes highly subjective assumptions based on long-term predictions, including the expected stock price volatility and average life of each option grant.

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

| | Quarter Ended March 31, | |
|-------------------------------|------------------------------------|-------------|
| | 2007 | 2006 |
| Weighted Average Assumptions: | | |
| Dividend yield | 4.20% | 3.81% |
| Expected volatility | 33.72% | 34.26% |
| Risk-free interest rate | 4.33% | 4.19% |
| 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.

NOTE 2 INVESTMENT SECURITIES:

The amortized cost, gross unrealized gains and losses, fair value, and weighted average yield of the investment securities as of March 31, 2007 and December 31, 2006, were as follows:

Table of Contents

March 31, 2007 (In thousands)

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
|---|---------------------|------------------------------|-------------------------------|---------------------|------------------------------|
| Available-for-sale | | | | | |
| Obligations of US Government sponsored agencies | \$ 900,000 | \$ 3,075 | \$ 180 | 902,895 | 5.87% |
| Puerto Rico Government and agency obligations | 20,273 | 85 | 492 | 19,866 | 5.68% |
| Corporate bonds and other | 25,548 | 130 | | 25,678 | 5.80% |
| Total investment securities | 945,821 | 3,290 | 672 | 948,439 | |
| FNMA and FHLMC certificates | 144,597 | | 1,171 | 143,426 | 5.45% |
| GNMA certificates | 40,099 | 418 | 205 | 40,312 | 5.61% |
| Collateralized mortgage obligations (CMO s) | 697,942 | 51 | 4,228 | 693,765 | 5.48% |
| Total mortgage-backed-securities and CMO s | 882,638 | 469 | 5,604 | 877,503 | |
| Total securities available-for-sale | 1,828,459 | 3,759 | 6,276 | 1,825,942 | 5.68% |
| Held-to-maturity | | | | | |
| US Treasury securities | 15,007 | | 37 | 14,970 | 2.71% |
| Obligations of US Government sponsored agencies | 818,470 | 14 | 9,450 | 809,034 | 3.89% |
| Puerto Rico Government and agency obligations | 55,260 | | 3,324 | 51,936 | 5.29% |
| Total investment securities | 888,737 | 14 | 12,811 | 875,940 | |
| FNMA and FHLMC certificates | 687,831 | 1,131 | 9,049 | 679,913 | 5.04% |
| GNMA certificates | 177,316 | 243 | 2,092 | 175,467 | 5.35% |
| Collateralized mortgage obligations | 149,823 | 326 | 990 | 149,159 | 5.14% |
| Total mortgage-backed-securities and CMO s | 1,014,970 | 1,700 | 12,131 | 1,004,539 | |
| Total securities held-to-maturity | 1,903,707 | 1,714 | 24,942 | 1,880,479 | 4.57% |
| Total | \$ 3,732,166 | \$ 5,473 | \$ 31,218 | \$ 3,706,421 | 5.11% |

December 31, 2006 (In thousands)

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
|---|---------------------|------------------------------|-------------------------------|---------------------|------------------------------|
| Available-for-sale | | | | | |
| Puerto Rico Government and agency obligations | \$ 20,254 | \$ 64 | \$ 872 | \$ 19,446 | 5.68% |
| Corporate bonds and other | 50,598 | 520 | 2,347 | 48,771 | 6.11% |
| Total investment securities | 70,852 | 584 | 3,219 | 68,217 | |
| FNMA and FHLMC certificates | 150,099 | | 1,506 | 148,593 | 5.45% |
| GNMA certificates | 40,690 | 408 | 235 | 40,863 | 5.61% |
| Collateralized mortgage obligations (CMOs) | 722,419 | 7 | 5,139 | 717,287 | 5.48% |
| Total mortgage-backed-securities and CMO s | 913,208 | 415 | 6,880 | 906,743 | |
| Total securities available-for-sale | 984,060 | 999 | 10,099 | 974,960 | 5.52% |
| Held-to-maturity | | | | | |
| US Treasury securities | 15,022 | | 127 | 14,895 | 2.71% |
| Obligations of US Government sponsored agencies | 848,400 | 7 | 17,529 | 830,878 | 3.85% |
| Puerto Rico Government and agency obligations | 55,262 | | 3,961 | 51,301 | 5.29% |
| Total investment securities | 918,684 | 7 | 21,617 | 897,074 | |
| FNMA and FHLMC certificates | 713,171 | 628 | 11,529 | 702,270 | 5.04% |
| GNMA certificates | 182,874 | 215 | 2,176 | 180,913 | 5.35% |
| Collateralized mortgage obligations | 152,748 | 18 | 1,303 | 151,463 | 5.13% |
| Total mortgage-backed-securities and CMO s | 1,048,793 | 861 | 15,008 | 1,034,646 | |
| Total securities held-to-maturity | 1,967,477 | 868 | 36,625 | 1,931,720 | 4.55% |
| Total | \$ 2,951,537 | \$ 1,867 | \$ 46,724 | \$ 2,906,680 | 4.87% |

The amortized cost and fair value of the Group's investment securities available-for-sale and held-to-maturity at March 31, 2007, by contractual maturity, are shown in the next table. 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.

Table of Contents

| | (In thousands) | | | |
|-----------------------------------|---------------------|---------------------|---------------------|---------------------|
| | Available-for-sale | | Held-to-maturity | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Investment securities | | | | |
| Due within 1 year | \$ 2,000 | \$ 2,005 | \$ 164,979 | \$ 163,916 |
| Due after 1 to 5 years | | | 287,390 | 281,098 |
| Due after 5 to 10 years | 901,343 | 904,283 | 281,261 | 281,271 |
| Due after 10 years | 42,478 | 42,151 | 155,107 | 149,655 |
| | 945,821 | 948,439 | 888,737 | 875,940 |
| Mortgage-backed securities | | | | |
| Due within 1 year | 151 | 158 | | |
| Due after 1 to 5 years | 1,015 | 1,057 | | |
| Due after 10 years | 881,472 | 876,288 | 1,014,970 | 1,004,539 |
| | 882,638 | 877,503 | 1,014,970 | 1,004,539 |
| | \$ 1,828,459 | \$ 1,825,942 | \$ 1,903,707 | \$ 1,880,479 |

Securities not due on a single contractual maturity date, such as collateralized mortgage obligations, are classified in the period of final contractual maturity. The expected maturities of collateralized mortgage obligations and certain other securities may differ from their contractual maturities because they may be subject to prepayments or may be called by the issuer.

Proceeds from the sale of investment securities available-for-sale during the three-month period ended March 31, 2007 totaled \$23.0 million (March 31, 2006, \$15.2 million). Realized gains on those sales during the quarter was \$358,000 (March 31, 2006, gains of \$19,000). There were no losses in either periods.

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 March 31, 2007.

Table of Contents**Available-for-sale****(In thousands)**

| | Less than 12 months | | Fair |
|---|----------------------------|-------------------|--------------------|
| | Amortized | Unrealized | Value |
| | Cost | Loss | |
| Obligations of U.S. government entities | \$ 150,000 | \$ 180 | \$ 149,820 |
| Mortgage-backed securities and CMO s | 850,219 | 5,232 | 844,987 |
| | 1,000,219 | 5,412 | 994,807 |
| | 12 months or more | | Fair |
| | Amortized | Unrealized | Value |
| | Cost | Loss | |
| Puerto Rico Government and agency obligations | 14,102 | 492 | 13,610 |
| Mortgage-backed securities and CMO s | 8,517 | 372 | 8,145 |
| | 22,619 | 864 | 21,755 |
| | Amortized | Total | Fair |
| | Cost | Unrealized | Value |
| | | Loss | |
| Obligations of U.S. government entities | 150,000 | 180 | 149,820 |
| Puerto Rico Government and agency obligations | 14,102 | 492 | 13,610 |
| Mortgage-backed securities and CMO s | 858,736 | 5,604 | 853,132 |
| | \$1,022,838 | \$6,276 | \$1,016,562 |

Held-to-maturity**(In thousands)**

| | Less than 12 months | | Fair |
|--|----------------------------|-------------------|----------------|
| | Amortized | Unrealized | Value |
| | Cost | Loss | |
| Mortgage-backed securities and CMO s | \$ 176,252 | \$ 693 | \$ 175,559 |
| | 176,252 | 693 | 175,559 |
| | 12 months or more | | Fair |
| | Amortized | Unrealized | Value |
| | Cost | Loss | |
| US Treasury securities | 15,007 | 37 | 14,970 |
| Obligations of U.S government sponsored entities | 562,208 | 9,450 | 552,758 |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | | |
|---|------------------|---------------|------------------|
| Puerto Rico Government and agency obligations | 55,260 | 3,324 | 51,936 |
| Mortgage-backed securities and CMO s | 472,443 | 11,438 | 461,005 |
| | 1,104,918 | 24,249 | 1,080,669 |

| | Amortized Cost | Total Unrealized Loss | Fair Value |
|--|---------------------------|--------------------------------------|-----------------------|
| US Treasury securities | 15,007 | 37 | 14,970 |
| Obligations of U.S government sponsored entities | 562,208 | 9,450 | 552,758 |
| Puerto Rico Government and agency obligations | 55,260 | 3,324 | 51,936 |
| Mortgage-backed securities and CMO s | 648,695 | 12,131 | 636,564 |
| | \$1,281,170 | \$24,942 | \$1,256,228 |

Securities in an unrealized loss position at March 31, 2007 are mainly composed of securities issued or backed by U.S. government agencies and U.S. government sponsored agencies. The vast majority of these securities are rated the equivalent of AAA by nationally recognized rating organizations. The investment portfolio is structured primarily with 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. Management believes that the unrealized losses in the investment portfolio at March 31, 2007 are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuers. Also, Management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.

Table of Contents**NOTE 3 LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES:****Loans Receivable**

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, 2007, and December 31, 2006, was as follows:

| | (In thousands) | |
|---|---------------------|----------------------|
| | March 31, 2007 | December 31, 2006 |
| Residential mortgage loans | \$ 897,770 | \$ 899,162 |
| Home equity loans and secured personal loans | 35,219 | 36,270 |
| Commercial loans, mainly secured by real estate | 236,739 | 241,702 |
| Personal consumer loans and lines of credit | 33,419 | 35,772 |
| Loans receivable, gross | 1,203,147 | 1,212,906 |
| Less: deferred loan fees, net | (3,411) | (3,123) |
| Loans receivable | 1,199,736 | 1,209,783 |
| Allowance for loan losses | (8,046) | (8,016) |
| Loans receivable, net | 1,191,690 | 1,201,767 |
| Mortgage loans held-for-sale | 42,204 | 10,603 |
| Total loans, net | \$ 1,233,894 | \$ 1,212,370 |

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 the changes in the allowance for loan losses for the quarters ended March 31, 2007 and 2006.

The Group evaluates all loans, some individually, and others as homogeneous groups, for purposes of determining impairment. At March 31, 2007 and December 31, 2006, the total investment in impaired loans was \$1.7 million and \$2.0 million, respectively. The impaired loans were measured based on the fair value of collateral. The Group determined that no specific impairment allowance was required for such loans.

Table of Contents**NOTE 4 PLEDGED ASSETS**

At March 31, 2007, residential mortgage loans amounting to \$580,875,000 and investment securities with fair values amounting to \$6,287,000 were pledged to secure advances and borrowings from the FHLB. Investment securities with fair values totaling \$3,420,301, \$101,051,000, and \$8,463,000 at March 31, 2007, were pledged to secure securities sold under agreements to repurchase, public fund deposits and other funds, respectively. Also, investment securities with fair value totaling \$508,000 at March 31, 2007, were pledged to the Puerto Rico Treasury Department. As of March 31, 2007, investment securities available-for-sale and held-to-maturity not pledged amounted to \$69,045,000 and \$100,766,000, respectively. As of March 31, 2007, mortgage loans not pledged amounted to \$394,318,000.

NOTE 5 OTHER ASSETS

Other assets at March 31, 2007 and December 31, 2006 include the following:

| | (In thousands) | |
|--------------------------------------|----------------------|----------------------|
| | March 31, 2007 | December 31, 2006 |
| Investment in equity indexed options | \$ 39,746 | \$ 34,216 |
| Investment in limited partnership | 11,021 | 11,913 |
| Deferred charges | 977 | 1,037 |
| Prepaid expenses | 1,858 | 2,152 |
| Accounts receivable and other assets | 11,297 | 7,560 |
| Investment in Statutory Trusts | 1,086 | 1,086 |
| Goodwill | 2,006 | 2,006 |
| Servicing asset | 1,364 | 1,507 |
| | \$ 69,355 | \$ 61,477 |

NOTE 6 SUBORDINATED CAPITAL NOTES

Subordinated capital notes amounted to \$36,083,000 at March 31, 2007 and December 31, 2006.

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 and the Group recorded a \$915,000 loss related to the write-off of unamortized issuance cost of the note. The other subordinated capital note has a par value of \$36.1 million, bears interest based on 3-month LIBOR plus 295 basis points (8.30% at March 31, 2007; December 31, 2006 8.31%), 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 (September 2008). 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. On March 4, 2005, the Federal Reserve Board issued a final rule that continues to allow trust preferred securities to be included in Tier I regulatory

capital, subject to stricter quantitative and qualitative limits. Under this rule, 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.

Table of Contents**NOTE 7 OTHER BORROWINGS**

At March 31, 2007, 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 at March 31, 2007 mature as follows:

| | (In thousands) |
|-------------------------|-----------------------|
| | Balance |
| Due within 30 days | \$ 514,323 |
| Due after 3 to 5 years | 900,428 |
| Due after 5 to 10 years | 1,906,354 |
| | \$ 3,321,105 |

At March 31, 2007, the contractual maturities of advances from the FHLB by year are as follows:

| Year ending December 31, | (In thousands) |
|---------------------------------|---------------------------|
| | Advances from FHLB |
| 2007 | \$ 145,000 |
| 2008 | 50,000 |
| | \$ 195,000 |

NOTE 8 DERIVATIVES ACTIVITIES

The Group utilizes 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.

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. The Group decided to unwind all of its outstanding interest rate swaps with aggregate notional amounts of \$1.1 billion in two separate transactions in July and December 2006.

The Group offers its customers certificates of deposit with an option tied to the performance of the Standard & Poor's 500 stock market index. At the end of five years depositors receive a return equal to the greater of 15% of the principal in the account or 125% of the average increase in the month-end value of the 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.

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.

There were no derivatives designated as a hedge as of March 31, 2007 and December 31, 2006. Other derivatives not designated as a hedge consist of purchased options used to manage the exposure to the stock market on stock indexed deposits with notional amounts of \$146,295,000 and \$131,530,000 as of March 31, 2007 and December 31, 2006, respectively; embedded options on stock indexed deposits with notional amounts of \$138,571,000 and \$122,924,000 as of March 31, 2007 and December 31, 2006, respectively.

-14-

Table of Contents

During the quarters ended March 31, 2007 and 2006, gains of \$8.4 million and \$882,000, respectively, were recognized as earnings and reflected as Derivatives Activities in the unaudited consolidated statements of income, mainly due to the \$8.2 million gain recognized because of the elimination of the forecasted transactions on the cash flow hedges of the swaps previously terminated, which gains were previously included in other comprehensive income. During the quarter ended March 31, 2006, unrealized gains of \$9.9 million on derivatives designated as cash flow hedges were included in other comprehensive income (loss). There are no unrealized gains or losses at March 31, 2007.

At March 31, 2007 and December 31, 2006, the fair value of derivatives was recognized as either assets or liabilities in the unaudited consolidated statements of financial condition as follows: the purchased options used to manage the exposure to the stock market on stock indexed deposits represented an asset of \$39.7 million and \$34.2 million, respectively, presented in other assets; the options sold to customers embedded in the certificates of deposit represented a liability of \$37.7 million and \$32.2 million, respectively, recorded in deposits.

NOTE 9 SEGMENT REPORTING:

The Group segregates its businesses into the following major reportable segments: Banking, Treasury, and Financial Services. Management established the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. Other factors such as the Group's organization, nature of products, distribution channels and economic characteristics of the products were also considered in the determination of the reportable segments. The Group measures the performance of these reportable segments based on pre-established goals of different financial parameters such as net income, net interest income, loan production and fees generated. In June 2006, management decided to reclassify and present investment banking revenues in the Treasury segment rather than in the Financial Services segment. This reclassification was retroactively presented in the table below.

Banking includes the Bank's branches and mortgage banking, with traditional banking products such as deposits and mortgage, commercial and consumer loans. Mortgage banking activities are carried out by the Bank's mortgage banking division, whose principal activity is to originate mortgage loans for the Group's own portfolio. From time to time, if conditions so warrant, the Group may sell loans directly into the secondary market or securitize conforming loans into mortgage-backed securities certificates. The Group outsourced the servicing of mortgages included in the resulting mortgage-backed securities pools, as well as loans maintained in portfolio.

The Treasury segment encompasses all of the Group's asset and liability management activities such as: purchases and sales of investment securities, interest rate risk management, derivatives, and borrowings, as well as investment banking revenues on public offerings and private placements of debt and equity securities.

Financial services is comprised of the Bank's trust division (Oriental Trust), the brokerage subsidiary (Oriental Financial Services Corp.), the insurance agency subsidiary (Oriental Insurance, Inc.), and the pension plan administration subsidiary (Caribbean Pension Consultants, Inc.). The core operations of this segment are financial planning, money management and investment brokerage services, insurance sales, corporate and individual trust and retirement services, as well as pension plan administration services.

Intersegment sales and transfers, if any, are accounted for as if the sales or transfers were to third parties, that is, at current market prices. The accounting policies of the segments are the same followed by the Group, which are described in the Summary of Significant Accounting Policies included in the Group's Form 10-K. Following are the results of operations and the selected financial information by operating segment for the quarters ended March 31, 2007 and 2006:

Table of Contents

| | Unaudited - Quarters Ended March 31, (Dollars in thousands) | | | | | Consolidated Total |
|--|---|---------------------|-----------------------|---------------------|---------------------|-----------------------|
| | Banking | Treasury | Financial Services | Total Segments | Eliminations | |
| March 31, 2007 | | | | | | |
| Interest income | \$ 22,344 | \$ 39,083 | \$ 73 | \$ 61,500 | \$ | \$ 61,500 |
| Interest expense | (7,094) | (40,931) | (209) | (48,234) | | (48,234) |
| Net interest income | 15,250 | (1,848) | (136) | 13,266 | | 13,266 |
| Non-interest income | 1,397 | 8,952 | 4,902 | 15,251 | | 15,251 |
| Non-interest expenses | (12,051) | (731) | (3,045) | (15,827) | | (15,827) |
| Intersegment revenue | 948 | | | 948 | 948 | 1,896 |
| Intersegment expense | | (146) | (802) | (948) | (948) | (1,896) |
| Provision for loan losses | (1,075) | | | (1,075) | | (1,075) |
| Income before income taxes | \$ 4,469 | \$ 6,227 | \$ 919 | \$ 11,615 | \$ | \$ 11,615 |
| Total Assets as of March 31, 2007 | \$ 1,696,048 | \$ 3,901,554 | \$ 12,883 | \$ 5,610,485 | \$ (318,432) | \$ 5,292,053 |
| March 31, 2006 | | | | | | |
| Interest income | \$ 16,599 | \$ 39,357 | \$ 36 | \$ 55,992 | \$ | \$ 55,992 |
| Interest expense | (7,763) | (33,017) | | (40,780) | | (40,780) |
| Net interest income | 8,836 | 6,340 | 36 | 15,212 | | 15,212 |
| Non-interest income | 5,084 | 2,950 | 919 | 8,953 | | 8,953 |
| Non-interest expenses | (12,408) | (550) | (1,925) | (14,883) | | (14,883) |
| Intersegment revenue | 722 | | | 722 | (722) | |
| Intersegment expense | | | (722) | (722) | 722 | |
| Provision for loan losses | (1,101) | | | (1,101) | | (1,101) |
| Income before income taxes | \$ 1,133 | \$ 8,740 | \$ (1,692) | \$ 8,181 | \$ | \$ 8,181 |
| Total Assets as of March 31, 2006 | \$ 1,071,901 | \$ 3,877,854 | \$ 13,021 | \$ 4,962,776 | \$ (398,678) | \$ 4,564,098 |

NOTE 10 RECENT ACCOUNTING DEVELOPMENTS:**Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements**

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having

previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. Management is evaluating the impact that this accounting standard may have on the Group's consolidated financial statements.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115

On February 15, 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115. SFAS 159 provides an alternative measurement treatment for certain financial assets and financial liabilities, under an instrument-by-instrument election, that permits fair value to be used for both initial and subsequent measurement, with changes in fair value recognized in earnings. While SFAS 159 is effective for the Group beginning January 1, 2008, earlier adoption is permitted as of January 1, 2007, provided that the entity also adopts all of the requirements of SFAS 157. Management has decided not to pursue early adoption.

Table of Contents

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FIN 48. On January 1, 2007, the Group adopted FIN 48. FIN 48 establishes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Pursuant to FIN 48, the effects of a tax position are recognized in the financial statements when it is more likely than not, based on the technical merits, that the position will be sustained upon examination by the taxing authority. Conversely, previously recognized tax positions are derecognized when it is no longer more likely than not that the tax position would be sustained upon examination. FIN 48 also requires certain disclosures regarding unrecognized tax benefits and the amounts and classification of the related interest and penalties.

As of January 1, 2007, the Company's unrecognized tax benefit totaled \$7.0 million, of which \$1.3 million related to interest and penalties. No adjustment resulted from the implementation of FIN 48. In accordance with the Group's policy, any tax-related interest and/or penalties are classified as a component of income taxes in the consolidated statements of financial position and results of operations. The tax periods ended June 30, 2003, 2004, 2005 and December 31, 2005 and 2006 remain subject to examination by the Puerto Rico Department of Treasury.

-17-

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****SELECTED FINANCIAL DATA**

**FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006
(IN THOUSANDS, EXCEPT PER SHARE DATA)**

| | Quarter ended March 31, | | |
|--|------------------------------------|-----------------|-----------------|
| | 2007 | 2006 | Variance |
| EARNINGS PER SHARE AND DIVIDENDS DATA: | | | |
| Interest income | \$ 61,500 | \$ 55,992 | 9.8% |
| Interest expense | 48,234 | 40,780 | 18.3% |
| Net interest income | 13,266 | 15,212 | -12.8% |
| Provision for loan losses | 1,075 | 1,101 | -2.4% |
| Net interest income after provision for loan losses | 12,191 | 14,111 | -13.6% |
| Non-interest income | 15,251 | 8,953 | 70.3% |
| Non-interest expenses | 15,827 | 14,883 | 6.3% |
| Income before taxes | 11,615 | 8,181 | 42.0% |
| Income tax expense | 624 | 131 | 376.3% |
| Net Income | 10,991 | 8,050 | 36.5% |
| Less: dividends on preferred stock | (1,200) | (1,200) | 0.0% |
| Income available to common shareholders | \$ 9,791 | \$ 6,850 | 42.9% |
| PER SHARE DATA: | | | |
| Basic | \$ 0.40 | \$ 0.28 | 43.8% |
| Diluted | \$ 0.40 | \$ 0.28 | 44.0% |
| Average common shares outstanding | 24,472 | 24,613 | -0.6% |
| Average potential common share-options | 93 | 137 | -32.1% |
| Total average shares outstanding and equivalents | 24,565 | 24,750 | -0.7% |
| Book value per common share | \$ 11.04 | \$ 11.19 | -1.3% |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | | |
|--|----------|----------|--------|
| Market price at end of period | \$ 11.78 | \$ 14.45 | -18.5% |
| Cash dividends declared per common share | \$ 0.14 | \$ 0.14 | 0.0% |
| Cash dividends declared on common shares | \$ 3,427 | \$ 3,448 | -0.6% |
| Return on average assets (ROA) | 1.01% | 0.70% | 44.3% |
| Return on average common equity (ROE) | 14.54% | 9.94% | 51.7% |
| Equity-to-assets ratio | 6.39% | 7.53% | -15.1% |
| Efficiency ratio | 78.95% | 65.32% | 20.9% |
| Expense ratio | 0.86% | 0.66% | 30.3% |
| Interest rate spread | 0.89% | 1.08% | 9.3% |
| Interest rate margin | 1.18% | 1.37% | -35.0% |
| Number of financial centers | 25 | 24 | 4.2% |

| | March 31, 2007 | December 31, 2006 | Variance |
|--|-------------------|-------------------------|----------|
|--|-------------------|-------------------------|----------|

PERIOD END BALANCES AND CAPITAL RATIOS:

Investments and loans

| | | | |
|---|---------------------|---------------------|---------|
| Investments securities | \$ 3,780,885 | \$ 2,992,236 | 26.4% |
| Loans (including loans held-for-sale), net | 1,233,894 | 1,212,370 | 1.8% |
| Securities and loans sold but not yet delivered | 74,289 | 6,430 | 1055.4% |
| | \$ 5,089,068 | \$ 4,211,036 | 20.9% |

Deposits and Borrowings

| | | | |
|---|---------------------|---------------------|--------|
| Deposits | \$ 1,337,585 | \$ 1,232,988 | 8.5% |
| Repurchase agreements | 3,321,105 | 2,535,923 | 31.0% |
| Other borrowings | 234,222 | 246,551 | -5.0% |
| Securities and loans purchased but not yet received | 40,067 | | 100.0% |
| | \$ 4,932,979 | \$ 4,015,462 | 22.9% |

Stockholders equity

| | | | |
|------------------|-----------|-----------|------|
| Preferred equity | \$ 68,000 | \$ 68,000 | 0.0% |
| Common equity | 270,322 | 268,426 | 0.7% |

| | | | |
|---|---------------------|---------------------|--------------|
| | \$ 338,322 | \$ 336,426 | 0.6% |
| Capital ratios | | | |
| Leverage capital | 8.21% | 8.42% | -2.5% |
| Tier 1 risk-based capital | 19.15% | 21.57% | -11.2% |
| Total risk-based capital | 19.56% | 22.04% | -11.3% |
| Trust assets managed | \$ 1,850,912 | \$ 1,848,596 | 0.1% |
| Broker-dealer assets gathered | 1,101,542 | 1,143,668 | -3.7% |
| Assets managed | 2,952,454 | 2,992,264 | -1.3% |
| Assets owned | 5,292,053 | 4,373,690 | 21.0% |
| Total financial assets managed and owned | \$ 8,244,507 | \$ 7,365,954 | 11.9% |

-18-

Table of Contents

OVERVIEW OF FINANCIAL PERFORMANCE

Introduction

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

During the quarter ended March 31, 2007 the Group continued targeting the personal and commercial needs of mid and high net worth individuals and families, including professionals and owners of small and mid-size businesses, primarily in Puerto Rico. The results of these efforts reflected continued growth in lending activities and tight control over non-interest expenses.

During the fourth quarter of 2006, the Group completed a review of its available-for-sale (AFS) investment portfolio in light of asset/liability management considerations and changing market conditions, and strategically repositioned this portfolio. The repositioning involved open market sales of approximately \$865 million of securities with a weighted average yield of 4.60% at a loss of approximately \$16.0 million which was included as non-interest income in the accompanying consolidated financials statements. Following the sale, \$860 million of triple-A securities at a weighted average yield of 5.55% were purchased and classified as AFS. As part of this repositioning, the Group entered into a \$900 million, 5-year structured repurchase agreement (\$450 million non-put 1-year and \$450 million non-put 2-years) with a weighted average rate paid of 4.52%. Proceeds were used to repay repurchase agreements with a weighted average rate paid of 5.25%. In February 2007, the Group continued its strategic repositioning of the repurchase agreements portfolio, restructuring an additional \$1 billion of short-term borrowings, with a weighted average rate being paid of approximately 5.35%, into 10-year, non-put 2-year structured repurchased agreements, priced at 95 basis points under 90-day LIBOR (for a current rate of 4.40%). These strategic actions are expected to significantly improve the Group's net interest income position for 2007. Separately, the Group purchased in February 2007 approximately \$900 million in U.S. government agency securities for the AFS portfolio which were funded with a net spread of approximately 150 basis points, locked in for two years on \$750 million and one year on \$150 million. These securities are intended to replenish scheduled repayments and maturities of securities that occurred in 2006 and are expected to occur in 2007. Most of the actions we took to reposition the AFS portfolio and its funding in December 2006 did not take effect until January 2007, and the actions we took to further restructure our funding in February 2007 did not take effect until March 2007. Thus, we anticipate the full benefits of these changes should be reflected in the June 2007 quarter.

Income Available to Common Share holders

For the quarter ended March 31, 2007, the Group's income available to common shareholders totaled \$9.8 million, compared to \$6.9 million in the comparable year-ago quarter. Earnings per common share fully diluted was \$0.40 compared to \$0.28 in the year-ago quarter.

Return on Average Assets and Common Equity

Return on average common equity (ROE) for the quarter ended March 31, 2007 was 14.54%, which represents an increase of 51.7% from 9.94% for the quarter ended March 31, 2006. Return on average assets (ROA) for the quarter ended March 31, 2007 was 1.01% representing an increase of 44.3% from 0.70% the year ago-quarter.

Net Interest Income after Provision for Loan Losses

Net interest income after provision for loan losses decreased 12.8% for the quarter ended March 31, 2007, totaling \$13.3 million, compared with \$15.2 million for the same period in the previous year, but significantly improved as compared to the last three quarters due to the initial favorable effects of the above mentioned repositioning. Increases of 9.8% in interest income for the quarter ended March 31, 2007, as compared to same period last year was mainly due to higher loan volume and higher average yields on interest earning assets. These increases were more than offset by higher interest rates and increased volume on borrowings. Net interest margin for the March 31, 2007 quarter was 1.18%, compared to 1.37% for the year-ago period, and 0.72% for the quarter ended December 31, 2006.

Non-Interest Income

Total non-interest income was \$15.3 million for the quarter ended March 31, 2007, an increase of 70.3% over the March 31, 2006 quarter. This reflected year-over-year growth in commissions and fees from brokerage and insurance activities, trust activities, securities net gain and derivatives net gain, which more than offset declines in banking service revenues and mortgage banking activities and the absence of investment banking revenues. Commission and fees from brokerage and insurance activities increased 48.9% to \$4.8 million, reflecting the success of growth strategies at work in those businesses. Derivatives net gain of \$8.4 million, as compared to a small gain in the year-ago quarter, reflected the recognition of the remaining net gain, which had previously been included in other comprehensive income, from the July 2006 unwinding of interest rate swaps that had been used to hedge rising interest costs of short-term repurchase agreements.

-19-

Table of Contents**Non-Interest Expenses**

Non-interest expenses totaled \$15.8 million for the quarter ended March 31, 2007, compared to \$14.9 million, in the March 31, 2006 quarter, but a 16.3% decline from \$18.9 million when compared to the last quarter of 2006.

Income Tax Expense

The income tax expense was \$624,000 for the quarter ended March 31, 2007, compared to \$131,000 for the same period ended March 31, 2006. The current income tax provision is lower than the provision based on the statutory tax rate for the Group, which is 39.0%, due to the high level of tax-advantaged interest income earned on certain investments and loans, net of the disallowance of related expenses attributable to the exempt income. Exempt interest relates principally to interest earned on obligations of the United States and Puerto Rico governments and certain mortgage-backed securities, including securities held by the Group's international banking entity.

Group's Financial Assets

The Group's total financial assets include owned assets and the assets managed by the trust division, the securities broker-dealer subsidiary, and the private pension plan administration subsidiary. At March 31, 2007, total financial assets reached \$8.245 billion compared to \$7.366 billion at December 31, 2006, reflecting a 11.9% increase. There was 21.0% increase in assets owned when compared to December 31, 2006. Owned assets are approximately 99% owned by the Group's banking subsidiary.

The Group's trust division offers various types of individual retirement accounts (IRA) and manages 401(K) and Keogh retirement plans and custodian and corporate trust accounts, while Caribbean Pension Consultants, Inc. (CPC) manages the administration of private pension plans. At March 31, 2007, total assets managed by the Group's trust division and CPC amounted to \$1.851 billion, compared to the \$1.849 billion reported at December 31, 2006. The Group's securities broker-dealer subsidiary offers a wide array of investment alternatives to its client base such as tax-advantaged fixed income securities, mutual funds, stocks, bonds and money management wrap-fee programs. At March 31, 2007, total assets gathered by the securities broker-dealer from its customer investment accounts, decreased to \$1.102 billion compared to \$1.144 billion as of December 31, 2006.

Interest Earning Assets

The investment portfolio amounted to \$3.781 billion as of March 31, 2007, a 26.4% increase compared to \$2.992 billion as of December 31, 2006, while the loan portfolio increased 1.8% to \$1.234 billion as of March 31, 2007, compared to \$1.212 billion as of December 31, 2006. The increase in investment securities relates to the \$900 million purchase of U.S. Government agency securities for the AFS portfolio which were intended to replenish scheduled repayments and maturities during 2006 and those expected for 2007, and provide a balance to grow the investment portfolio as a result of our strategy to deal with the current market rates scenario.

Mortgage loan portfolio totaled \$971.8 million as of March 31, 2007, a 3.11% increase from \$942.9 million at December 31, 2006, and 41.1% increase from \$688.6 million a year ago. Mortgage loan production totaled \$50.9 million, a 19.4% decrease compared to the same quarter of the prior fiscal year, excluding purchases from third party originators. Mortgage loans purchased amounted to \$4.6 million for the quarter ended March 31, 2007, compared to \$7.7 million for the March 31, 2006 period.

Interest Bearing Liabilities

Deposits of \$1.338 billion at March 31, 2007 increased 8.5% compared to December 31, 2006, due to the continued success of Oriental Money savings account products. Borrowings at March 31, 2007 totaled \$3.555 billion, an increase of 27.8% from December 31, 2006, primarily due to the Group's use of repurchase agreements.

Stockholders' Equity

Stockholders' equity as of March 31, 2007, was \$338.3 million, compared to \$336.4 million as of December 31, 2006, reflecting increased mark-to-market valuations in the available-for-sale portfolio.

The Group continues to be well-capitalized, with ratios significantly above regulatory capital adequacy guidelines. At March 31, 2007, Tier 1 Leverage Capital Ratio was 8.21% (2.1 times the minimum of 4.00%), Tier 1 Risk-Based Capital Ratio was 19.15% (4.8 times the minimum of 4.00%), and Total Risk-Based Capital Ratio was 19.56% (2.4 times the minimum of 8.00%).

Table of Contents**Dividends**

During the quarter ended March 31, 2007 and 2006, the Group declared cash dividends of \$3.4 million and \$1.2 million on its common and preferred stocks, respectively.

TABLE 1 QUARTERLY ANALYSIS OF NET INTEREST INCOME AND CHANGES DUE TO VOLUME/RATE

FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006

(Dollars in thousands)

| | Interest | | | Average rate | | | Average balance | | |
|--|-----------------|-----------------|------------------|--------------|--------------|----------------------|-------------------|-------------------|------------------|
| | 2007 | 2006 | Variance in % | 2007 | 2006 | Variance in BP | 2007 | 2006 | Variance in % |
| A TAX EQUIVALENT SPREAD | | | | | | | | | |
| Interest-earning assets | \$61,500 | \$55,992 | 9.8% | 5.46% | 5.04% | 42 | \$4,505,506 | \$4,441,440 | 1.4% |
| Tax equivalent adjustment | 14,661 | 13,113 | 11.8% | 1.30% | 1.18% | 12 | | | 0.0% |
| Interest-earning assets tax equivalent | 76,161 | 69,105 | 10.2% | 6.76% | 6.22% | 54 | 4,505,506 | 4,441,440 | 1.4% |
| Interest-bearing liabilities | 48,234 | 40,780 | 18.3% | 4.57% | 3.96% | 61 | 4,219,158 | 4,120,445 | 2.4% |
| Tax equivalent net interest income / spread | \$27,927 | \$28,325 | -1.4% | 2.19% | 2.26% | (7) | \$ 286,348 | \$ 320,995 | -10.8% |
| Tax equivalent interest rate margin | | | | 2.48% | 2.55% | (7) | | | |
| B NORMAL SPREAD | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Investments: | | | | | | | | | |
| Investment securities | \$39,474 | \$39,319 | 0.4% | 4.88% | 4.56% | 32 | \$3,237,580 | \$3,450,729 | -6.2% |
| Investment management fees | (290) | (319) | -9.1% | -0.04% | -0.04% | 0 | | | 0.0% |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | | | | | | | | |
|--------------------------------------|---------------|---------------|--------------|--------------|--------------|-----------|------------------|------------------|--------------|
| Total investment securities | 39,184 | 39,000 | 0.5% | 4.84% | 4.52% | 32 | 3,237,580 | 3,450,729 | -6.2% |
| Trading securities | 11 | (1) | -1200.0% | 3.90% | -2.74% | 664 | 1,127 | 146 | 671.9% |
| Money market investments | 456 | 740 | -38.4% | 5.84% | 4.30% | 154 | 31,230 | 68,810 | -54.6% |
| | 39,651 | 39,739 | -0.2% | 4.85% | 4.52% | 33 | 3,269,937 | 3,519,685 | -7.1% |
| Loans: | | | | | | | | | |
| Mortgage | 16,329 | 11,128 | 46.7% | 6.75% | 7.02% | (27) | 967,003 | 634,100 | 52.5% |
| Commercial | 4,601 | 4,165 | 10.5% | 7.86% | 6.63% | 123 | 234,105 | 251,421 | -6.9% |
| Consumer | 919 | 960 | -4.3% | 10.67% | 10.60% | 7 | 34,461 | 36,234 | -4.9% |
| | 21,849 | 16,253 | 34.4% | 7.07% | 7.05% | 2 | 1,235,569 | 921,755 | 34.0% |
| | 61,500 | 55,992 | 9.8% | 5.46% | 5.04% | 42 | 4,505,506 | 4,441,440 | 1.4% |
| Interest-bearing liabilities: | | | | | | | | | |
| Deposits: | | | | | | | | | |
| Non-interest bearing deposits | | | | | | | | | |
| | | | 0.0% | | | 0 | 36,709 | 42,044 | -12.7% |
| Now accounts | 203 | 218 | -6.9% | 1.14% | 1.02% | 12 | 71,445 | 85,186 | -16.1% |
| Savings | 2,916 | 257 | 1035.1% | 4.09% | 1.20% | 289 | 285,491 | 85,991 | 232.0% |
| Certificates of deposit | 9,250 | 10,023 | -7.7% | 4.52% | 3.91% | 61 | 819,262 | 1,025,795 | -20.1% |
| | 12,370 | 10,498 | 17.8% | 4.08% | 3.39% | 69 | 1,212,907 | 1,239,016 | -2.1% |
| Borrowings: | | | | | | | | | |
| Repurchase agreements | 33,095 | 27,554 | 20.1% | 4.77% | 4.44% | 33 | 2,772,978 | 2,480,470 | 11.8% |
| Interest rate risk management | (773) | (1,319) | -41.4% | -0.11% | -0.21% | 10 | | | 0.0% |
| Financing fees | 467 | 128 | 264.7% | 0.07% | 0.02% | 5 | | | 0.0% |
| Total repurchase agreements | 32,789 | 26,363 | 24.4% | 4.73% | 4.25% | 48 | 2,772,978 | 2,480,470 | 11.8% |
| FHLB advances | 1,924 | 2,348 | -18.1% | 4.64% | 3.08% | 156 | 165,991 | 305,071 | -45.6% |
| Subordinated capital notes | 758 | 1,297 | -41.6% | 8.40% | 7.19% | 121 | 36,083 | 72,166 | -50.0% |
| Term notes | 188 | 157 | 20.1% | 5.32% | 4.19% | 113 | 14,167 | 15,000 | -5.6% |
| Other borrowings | 205 | 117 | 75.1% | 4.81% | 5.37% | (56) | 17,032 | 8,722 | 95.3% |
| | 35,864 | 30,282 | 18.4% | 4.77% | 4.20% | 57 | 3,006,251 | 2,881,429 | 4.3% |
| | 48,234 | 40,780 | 18.3% | 4.57% | 3.96% | 61 | 4,219,158 | 4,120,445 | 2.4% |

| | | | | | | |
|--|-----------------|-----------------|---------------|--------------|----------------|---|
| Net interest income / spread | \$13,266 | \$15,212 | -12.8% | 0.89% | 1.08% | (19) |
| Interest rate margin | | | | 1.18% | 1.37% | (19) |
| Excess of average interest-earning assets over average interest-bearing liabilities | | | | | | \$ 286,348 \$ 320,995 -10.8% |
| Average interest-earning assets over average interest-bearing liabilities ratio | | | | | 106.79% | 107.79% |

| C. Changes in net interest income due to: | Volume | Rate | Total |
|--|-------------------|-----------------|------------------|
| Interest Income: | | | |
| Investments | \$ (2,920) | 2,832 | (88) |
| Loans | 5,549 | 47 | 5,596 |
| | 2,629 | 2,879 | 5,508 |
| Interest Expense: | | | |
| Deposits | \$ (225) | 2,097 | 1,872 |
| Repurchase agreements | 10,766 | (4,341) | 6,425 |
| Other borrowings | (1,951) | 1,108 | (843) |
| | 8,590 | (1,136) | 7,454 |
| Net Interest Income | \$ (5,961) | \$ 4,015 | \$(1,946) |

Table of Contents

Net interest income is a function of the difference between rates earned on the Group's interest-earning assets and rates paid on its interest-bearing liabilities (interest rate spread) and the relative amounts of its interest-earning assets and interest-bearing liabilities (interest rate margin). Typically, bank liabilities re-price in line with changes in short-term rates, while many asset positions are affected by longer-term rates. The Group constantly monitors the composition and re-pricing of its assets and liabilities to maintain its net interest income at adequate levels.

For the quarter ended March 31, 2007, net interest income amounted to \$13.3 million, a decrease of 12.8% from \$15.2 million in the same period of the previous year. The decrease for the quarter reflects a 9.8% increase in interest income, due to a \$2.6 million positive volume variance and a \$2.9 million positive rate variance, more than offset by an increase on 18.3% in interest expense, caused by an increase of \$8.6 from borrowings volume and \$(1.1) million due to interest rate changes. Interest rate spread dropped 19 basis points, to 0.89% from 1.08% in the March 31, 2006 quarter. This decline is a result of an increase of 42 basis points, in the combined average yield of investments and loans for the quarter and an increase of 61 basis points, caused by an increase in the average cost of funds.

For the quarter ended March 31, 2007, the average balance of total interest-earnings assets grew 1.4% to \$4.506 billion versus \$4.441 billion for the same periods of the previous year. The increase in the average balance reflects decrease of 7.1% in the investment portfolio to \$3.270 billion and a growth of 34.0% in loans, to \$1.236 billion for the quarter. Most of the dollar increase in loans came from the residential mortgage loan portfolio average balance, which increased by 52.5% to \$967.0 million for the quarter ended March 31, 2007 from \$634.1 million for the quarter ended March 31, 2006.

For the quarter ended March 31, 2007, the average yield on interest-earning assets was 5.46%, compared to 5.04% in the comparable year-ago-period. Higher average yields were due to increases of the investment and loan portfolio yields. The investment portfolio yield increased 4.85% in the quarter ended March 31, 2007, versus 4.52% in the corresponding year ago quarter, due to additions of higher yield investments. The increase was due to the AFS repositioning done late last year and during the March 31, 2007 quarter.

For the quarter ended March 31, 2007, interest expense increased 18.3% to \$48.2 million from \$40.8 million for the year ago quarter, resulting from both higher volume and rate variances.

For the quarter ended March 31, 2007, the cost of deposits increased 69 basis points to 4.08% as compared to 3.39% in the year-ago quarter. The increase reflects higher average rates paid on higher balances, specifically in savings accounts. For the quarter ended March 31, 2007, the cost of borrowings increased 57 basis points to 4.77%, as compared to 4.20% in the year-ago quarter. The increase was mainly the result of higher average rates paid on increased volume of repurchase agreements. Cost of repurchase agreements increased 33 basis points to 4.77% from 4.44% for the quarter ended March 31, 2007, but lower than the 5.41% from the quarter ended December 31, 2006 due to the repurchase agreement repositioning, lowering funding cost. The cost of FHLB advances increased 156 basis points to 4.64% versus 3.08% for the quarter ended March 31, 2006.

Table of Contents**TABLE 2 NON-INTEREST INCOME SUMMARY:
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006**

(Dollars in thousands)

| | Quarter ended March 31, | | |
|--|-------------------------|-----------------|----------------|
| | 2007 | 2006 | Variance % |
| Mortgage banking activities | \$ 62 | \$ 436 | -85.8% |
| Commissions and fees from brokerage and insurance activities | 4,843 | 3,252 | 48.9% |
| Investment banking revenues | | 1,709 | -100.0% |
| Non-banking service revenues | 4,905 | 5,397 | -9.1% |
| Fees on deposit accounts | 1,225 | 1,418 | -13.6% |
| Bank service charges and commissions | 594 | 619 | -4.0% |
| Other operating revenues | 55 | 139 | -60.4% |
| Bank service revenues | 1,874 | 2,176 | -13.9% |
| Securities available for sale gains | 358 | 19 | 1784.2% |
| Trading securities net gain | | 28 | -100.0% |
| Derivatives net gain | 8,418 | 882 | 854.4% |
| Securities, derivatives and trading activities | 8,776 | 929 | 844.7% |
| Income (loss) from investment in limited liability partnership | (891) | 304 | -393.1% |
| Other income | 587 | 147 | 299.3% |
| Other non-interest income (loss) | (304) | 451 | -167.4% |
| Total non-interest income | \$ 15,251 | \$ 8,953 | 70.4% |

Non-interest income, the second largest source of earnings, is affected by the amount of securities and trading transactions, the level of trust assets under management, transactions generated by the gathering of financial assets by the securities broker-dealer subsidiary, the level of investment and mortgage banking activities, and the fees generated from loans, deposit accounts, and insurance.

Non-interest income totaled \$15.3 million in the quarter ended March 31, 2007, an increase of 70.4% when compared to \$9.0 million in the same period of the previous year. Improvement reflects increases in commissions and fees from brokerage, trust, insurance, derivatives net gain, and securities net gain, partially offset by less mortgage banking activities for the quarter ended March 31, 2007.

Non-banking service revenues, generated from trust, mortgage banking, investment banking, brokerage, and insurance activities, is one of the principal components of non-interest income. For the quarter ended March 31, 2007, these

revenues decreased 9.1% to \$4.9 million from \$5.4 million for the year-ago period. Mortgage banking activities decreased 85.8% to \$62,000 from \$436,000 in the year-ago quarter. Commissions and fees from brokerage and insurance activities increased 48.9% to \$4.8 million from \$3.3 million in the year-ago quarter. Growth reflected the general improvement in the equity markets. Investment banking revenues decreased by \$1.7 million from the year-ago quarter.

Banking service revenue, another major component of non-interest income, consists primarily of fees generated by deposit accounts, electronic banking services, and bank service commissions. For the quarter ended March 31, 2007, these revenues decreased 13.9% to \$1.9 million compared to the year-ago quarter, reflecting reduced consumer banking activity. Fees on deposit accounts decreased 13.6% to \$1.2 million from \$1.4 million in the year-ago quarter. Bank service charges, commissions decreased 4.0% to \$594,000 from \$619,000 in the year-ago quarter, reflecting lower transactional volume in the Bank's debit and credit cards.

For the quarter ended March 31, 2007 gains from securities, derivatives and trading activities was \$8.8 million compared to \$929,000 for the year-ago quarter. The Group previously announced a net gain of approximately \$11 million from the July 2006 unwinding of interest rate swaps that had been used to hedge rising interest costs of short-term repurchase agreements. This gain was included in other comprehensive income, and was being recognized into earnings as a reduction of interest expense on remaining short-term borrowings. The recent repurchase agreements restructuring, however, significantly reduced the Group's short-term borrowings during the March 2007 quarter, eliminating the forecasted transactions that the swaps were intended to hedge. As a result, Oriental recognized the remaining balance of \$8.2 million (equal to \$0.33 per diluted share) of the gain as non-interest income in the quarter ended March 31, 2007.

Table of Contents

**TABLE 3 NON-INTEREST EXPENSES SUMMARY
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006
(Dollars in thousands)**

| | Quarter Ended March 31, | | Variance % |
|--|-------------------------|------------------|---------------|
| | 2007 | 2006 | |
| Compensation and employee benefits | \$ 6,745 | \$ 6,173 | 9.3% |
| Occupancy and equipment | 2,994 | 2,889 | 3.6% |
| Advertising and business promotion | 793 | 937 | -15.4% |
| Director and investors relations | 531 | 144 | 311.6% |
| Professional and service fees | 1,538 | 1,624 | -5.3% |
| Communications | 338 | 447 | -24.4% |
| Loan servicing expenses | 523 | 455 | 14.9% |
| Taxes, other than payroll and income taxes | 448 | 600 | -25.3% |
| Electronic banking charges | 458 | 468 | -2.1% |
| Printing, postage, stationery and supplies | 202 | 186 | 8.6% |
| Insurance | 216 | 213 | 1.4% |
| Other operating expenses | 1,041 | 747 | 36.6% |
| Total non-interest expenses | \$ 15,827 | \$ 14,883 | 6.3% |
| Relevant ratios and data: | | | |
| Compensation and benefits to non-interest expenses | 42.6% | 41.5% | |
| Compensation to total assets | 0.51% | 0.54% | |
| Average compensation per employee (annualized) | \$ 50.1 | \$ 46.8 | |
| Average number of employees | 539 | 528 | |
| Assets owned per employee | \$ 9,818 | \$ 8,644 | |

Non-interest expenses for the quarter ended March 31, 2007, were \$15.8 million, compared to \$14.9 million in the year-ago quarter, with an efficiency ratio of 78.95% compared to 65.32% in the quarter ended March 31, 2006. The efficiency ratio measures how much of a company's revenue is used to pay operating expenses. The Group computes its efficiency ratio by dividing non-interest expenses by the sum of its net interest income and recurring non-interest income, but excluding gains on sale of investment securities, derivatives gains or losses and other income that may be considered volatile in nature. Management believes that the exclusion of those items would permit greater comparability for analytical purposes.

The Group has been successful in limiting expense growth to those areas that directly contribute to increase efficiency, service quality, and profitability. Non-interest expenses increased 6.3% compared to the year-ago quarter ended March 31, 2006, but declined 16.3% from \$18.9 million for the quarter ended December 31, 2006.

Compensation and employee benefits, the largest non-interest expense category accounted for 42.6% of the total non-interest expense, for the quarter ended March 31, 2007. Total compensation and employee benefits amounted to \$6.7 million for the quarter ended March 31, 2007, compared to \$6.2 million in the comparable year-ago period.

Table of Contents

**TABLE 4 ALLOWANCE FOR LOAN LOSSES SUMMARY
FOR THE QUARTERS ENDED MARCH 31, 2007 AND 2006
(Dollars in thousands)**

| | Quarter Ended March 31, | | Change |
|---------------------------------------|--------------------------------|-----------------|---------------|
| | 2007 | 2006 | in |
| | | | % |
| Balance at beginning of period | \$ 8,016 | \$ 6,630 | 20.9% |
| Provision for loan losses | 1,075 | 1,101 | -2.4% |
| Net credit losses see Table 5 | (1,045) | (571) | 83.0% |
| Balance at end of period | \$ 8,046 | \$ 7,160 | 12.4% |

Selected Data and Ratios:

| | | | |
|--------------------------------------|--------------|------------|--------|
| Outstanding gross loans at March 31, | \$ 1,241,941 | \$ 948,400 | 31.0% |
| Recoveries to net charge-offs | 10.45% | 15.91% | -34.3% |
| Allowance coverage ratio | | | |
| Total loans | 0.65% | 0.75% | 13.3% |
| Non-performing loans | 18.34% | 23.91% | -23.3% |
| Non-mortgage non-performing loans | 212.86% | 140.17% | 51.9% |

**TABLE 5 NET CREDIT LOSSES STATISTICS
(Dollars in thousands)**

| | Quarter Ended March 31, | | Change |
|-------------------|--------------------------------|--------------|---------------|
| | 2007 | 2006 | in |
| | | | % |
| Mortgage | | | |
| Charge-offs | \$ (546) | \$ (199) | 174.4% |
| Recoveries | | | 0.0% |
| | (546) | (199) | 175.0% |
| Commercial | | | |
| Charge-offs | | (25) | -100.0% |
| Recoveries | 10 | 7 | 42.9% |
| | 10 | (18) | 155.6% |
| Consumer | | | |
| Charge-offs | (621) | (455) | 36.5% |
| Recoveries | 112 | 101 | 10.9% |
| | (509) | (354) | 43.8% |

Net credit losses

| | | | |
|-------------------|-------------------|-----------------|--------------|
| Total charge-offs | (1,167) | (679) | 71.9% |
| Total recoveries | 122 | 108 | 13.0% |
| | \$ (1,045) | \$ (571) | 83.1% |

Net credit losses (recoveries) to average loans outstanding**(1):**

| | | |
|--------------|--------------|--------------|
| Mortgage | 0.23% | 0.13% |
| Commercial | (0.02%) | 0.03% |
| Consumer | 5.91% | 3.91% |
| Total | 0.34% | 0.25% |

Average loans:

| | | | |
|--------------|---------------------|-------------------|--------------|
| Mortgage | \$ 967,003 | \$ 634,100 | 52.5% |
| Commercial | 234,105 | 251,421 | -6.9% |
| Consumer | 34,461 | 36,234 | -4.9% |
| Total | \$ 1,235,569 | \$ 921,755 | 34.0% |

(1) Annualized ratios

Table of Contents**TABLE 6 ALLOWANCE FOR LOSSES BREAKDOWN**
(Dollars in thousands)

| | March 31, 2007 | December 31, 2006 | Change in % | March 31, 2006 |
|---|----------------------|-------------------------|-------------------|----------------------|
| Allowance for loan losses breakdown: | | | | |
| Mortgage | \$ 4,139 | \$ 3,721 | 11.2% | \$ 3,312 |
| Commercial | 1,931 | 1,831 | 5.5% | 1,633 |
| Consumer | 1,877 | 1,944 | -3.4% | 1,776 |
| Unallocated allowance | 99 | 520 | -81.0% | 439 |
| | \$ 8,046 | \$ 8,016 | 0.4% | \$ 7,160 |
| Allowance composition: | | | | |
| Mortgage | 51.4% | 46.4% | | 46.3% |
| Commercial | 24.0% | 22.8% | | 22.8% |
| Consumer | 23.3% | 24.3% | | 24.8% |
| Unallocated allowance | 1.2% | 6.5% | | 6.1% |
| | 100.0% | 100.0% | | 100.0% |

The provision for loan losses for the quarter ended March 31, 2007, totaled \$1,075,000, a 2.3% decrease from the \$1,101,000 reported for the same quarter of the previous year. Based on an analysis of the credit quality and composition of its loan portfolio, the Group determined that the provision for the first quarter of the current year was adequate in order to maintain the allowance for loan losses at an appropriate level.

Net credit losses for the quarter increased 83.0%, from \$571,000 (0.25% of average loans outstanding) in the quarter ended March 31, 2006, to \$1,045,000 (0.34%) in the quarter ended March 31, 2007, but remained similar to the \$1.1 million (0.36%) for the quarter ended December 31, 2006.

The increase in the quarter was primarily due to higher net credit losses for consumer loans and mortgage loans. For the first quarter of the current year, the net credit losses average ratio was 0.34% compared to 0.25% for the same quarter of the prior fiscal year. Non-performing loans of \$43.9 million as of March 31, 2007 were 46.5% higher than the \$29.9 million as of March 31, 2006 (Table 9). The increase in non-performing loans reflects overall residential mortgage loan growth and the effects of the current economic recession in Puerto Rico.

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 possible losses.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical loss experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

Larger commercial loans that exhibit potential or observed credit weaknesses are subject to individual review and grading. Where appropriate, allowances are allocated to individual loans based on management's estimate of the borrower's ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Group.

Included in the review of individual loans are those that are impaired. A loan is considered impaired when, based on current information and events, it is probable that the Group will be unable to collect the scheduled payments of

principal or interest when due according to the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral, if the loan is collateral dependent.

Table of Contents

The Group evaluates all loans, some individually and others as homogeneous groups, for purposes of determining impairment. The portfolios of mortgages and consumer loans are considered homogeneous and are evaluated collectively for impairment. For the commercial loans portfolio, all loans over \$250,000 are evaluated for impairment. At March 31, 2007, the total investment in impaired loans was \$1.7 million, compared to \$2.0 million at December 31, 2006. Impaired loans are measured based on the fair value of collateral. The Group determined that no specific impairment allowance was required for such loans.

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:

1. Overall historical loss trends; and
2. Other information including underwriting standards, economic trends and unusual events

Loan loss ratios and credit risk categories are updated quarterly and are applied in the context of GAAP and the Joint Interagency Guidance on the importance of depository institutions having prudent, conservative, but not excessive loan loss allowances that fall within an acceptable range of estimated losses. While management uses available information in estimating possible loan losses, future changes to the allowance may be necessary, based on factors beyond the Group's control, such as factors affecting general economic conditions.

An unallocated allowance is established recognizing the estimation risk associated with the rating system and with the specific allowances. It is based upon management's evaluation of various conditions, the effects of which are not directly measured in determining the rating system and the specific allowances. These conditions include then-existing general economic and business conditions affecting our key lending areas; credit quality trends, including trends in non-performing loans expected to result from existing conditions, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, recent loss experience in particular segments of the portfolio, regulatory examination results, and findings by the Group's management. The evaluation of the inherent loss regarding these conditions involves a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments.

Table of Contents**FINANCIAL CONDITION****TABLE 7 ASSETS SUMMARY AND COMPOSITION**

(Dollars in thousands)

| | March 31, 2007 | December 31, 2006 | Variance % | March 31, 2006 |
|--|-------------------|-------------------------|---------------|-------------------|
| Investments: | | | | |
| Mortgage-backed securities | \$ 1,892,473 | \$ 1,955,566 | -3.2% | \$ 1,966,339 |
| U.S. Government and agency obligations | 1,733,526 | 863,019 | 100.9% | 1,249,631 |
| P.R. Government and agency obligations | 100,801 | 100,729 | 0.1% | 90,035 |
| Other investment securities | 34,889 | 54,315 | -35.8% | 89,338 |
| Short-term investments | 5,000 | 5,000 | 0.0% | 70,288 |
| FHLB stock | 14,197 | 13,607 | 4.3% | 19,403 |
| | 3,780,886 | 2,992,236 | 26.4% | 3,485,034 |
| Loans: | | | | |
| Mortgage | 929,578 | 932,309 | -0.3% | 675,553 |
| Commercial, mainly secured by real estate | 236,739 | 241,702 | -2.1% | 221,399 |
| Consumer | 33,419 | 35,772 | -6.6% | 38,450 |
| | 1,199,736 | 1,209,783 | -0.8% | 935,402 |
| Allowance for loan losses | (8,046) | (8,016) | 0.4% | (7,160) |
| | 1,191,690 | 1,201,767 | -0.8% | 928,242 |
| Mortgage loans held for sale | 42,204 | 10,603 | 298.0% | 12,998 |
| | 1,233,894 | 1,212,370 | 1.8% | 941,240 |
| Securities sold but not yet delivered | | | | |
| | 74,289 | 6,430 | 1055.3% | 1,192 |
| | 5,089,069 | 4,211,036 | 20.9% | 4,427,466 |
| Other assets: | | | | |
| Cash and due from banks | 64,413 | 34,070 | 89.1% | 13,227 |
| Accrued interest receivable | 30,482 | 27,940 | 9.1% | 29,539 |
| Premises and equipment, net | 19,853 | 20,153 | -1.5% | 15,307 |
| Deferred tax asset, net | 13,562 | 14,150 | -4.2% | 13,845 |
| Foreclosed real estate | 5,320 | 4,864 | 9.4% | 4,312 |
| Other assets | 69,354 | 61,477 | 12.8% | 60,402 |
| | 202,984 | 162,654 | 24.8% | 136,632 |

| | | | | |
|---------------------|---------------------|---------------------|--------------|---------------------|
| Total assets | \$ 5,292,053 | \$ 4,373,690 | 21.0% | \$ 4,564,098 |
|---------------------|---------------------|---------------------|--------------|---------------------|

Investment portfolio composition:

| | | | | |
|--|---------------|---------------|--|---------------|
| Mortgage-backed securities | 50.1% | 65.4% | | 56.4% |
| U.S. Government and agency obligations | 45.8% | 28.8% | | 35.9% |
| P.R. Government and agency obligations | 2.7% | 3.4% | | 2.6% |
| FHLB stock, short term investments and other investment securities | 1.4% | 2.4% | | 5.1% |
| | 100.0% | 100.0% | | 100.0% |

Loan portfolio composition:

| | | | | |
|---|---------------|---------------|--|---------------|
| Mortgage | 77.5% | 77.1% | | 72.6% |
| Commercial, mainly secured by real estate | 19.7% | 20.0% | | 23.3% |
| Consumer | 2.8% | 3.0% | | 4.1% |
| | 100.0% | 100.0% | | 100.0% |

At March 31, 2007, the Group's total assets amounted to \$5.292 billion, an increase of 21.0%, when compared to \$4.374 billion at December 31, 2006. At March 31, 2007, interest-earning assets were \$5.089 billion, a 20.9% increase compared to \$4.211 billion at December 31, 2006.

Investments principally consist of money market instruments, U.S. government bonds, mortgage-backed securities, collateralized mortgage obligations, and Puerto Rico government bonds. At March 31, 2007, the investment portfolio increased 26.4% to \$3.781 billion, from \$2.992 billion as of December 31, 2006. The increase reflects securities purchased during the quarter amounting to approximately \$900 million.

At March 31, 2007, the Group's loan portfolio, increased by 1.77% to \$1.234 billion when compared to \$1.212 billion at December 31, 2006. Loan production and purchases for the quarter ended March 31, 2007, declined 22.0% to \$72.3 million, compared to the quarter ended March 31, 2006.

Table of Contents

| | March 31, 2007 | December 31, 2006 | Change in % | March 31, 2006 |
|--|-------------------------------|----------------------------------|----------------------------|-------------------------------|
| Non-performing assets: | | | | |
| Non- Accruing Loans | \$ 17,106 | \$ 17,845 | -4.1% | \$ 17,674 |
| Accruing Loans | 26,765 | 20,453 | 30.9% | 12,267 |
| Total Non-performing loans | 43,871 | 38,298 | 14.6% | 29,941 |
| Foreclosed real estate | 5,320 | 4,864 | 9.4% | 4,312 |
| | \$ 49,191 | \$ 43,162 | 14.0% | \$ 34,253 |
| Non-performing assets to total assets | 0.93% | 0.99% | | 0.75% |
| | | | | |
| | March 31, 2007 | December 31, 2006 | Change in % | March 31, 2006 |
| Non-performing loans: | | | | |
| Mortgage | \$ 40,091 | \$ 34,404 | 16.5% | \$ 24,833 |
| Commercial, mainly secured by real estate | 3,115 | 3,167 | -1.6% | 4,824 |
| Consumer | 665 | 727 | -8.5% | 284 |
| Total | \$ 43,871 | \$ 38,298 | 14.6% | \$ 29,941 |
| | | | | |
| Non-performing loans composition: | | | | |
| Mortgage | 91.4% | 89.8% | | 82.9% |
| Commercial, mainly secured by real estate | 7.1% | 8.3% | | 16.1% |
| Consumer | 1.5% | 1.0% | | 0.9% |
| Total | 100.00% | 100.00% | | 100.00% |
| | | | | |
| Non-performing loans to: | | | | |
| Total loans | 3.53% | 3.14% | 12.42% | 3.16% |
| Total assets | 0.83% | 0.88% | -5.68% | 0.66% |
| Total capital | 12.97% | 11.38% | 13.97% | 8.71% |

At March 31, 2007, the Group's non-performing assets totaled \$49.2 million (0.93% of total assets) versus \$43.2 million (0.99% of total assets) at December 31, 2006. Foreclosed real estate properties increased by 9.4% to \$5.3 million, when compared to \$4.9 million reported as of December 31, 2006.

Table of Contents

At March 31, 2007, the allowance for loan losses to non-performing loans coverage ratio was 18.34%. Detailed information concerning each of the items that comprise non-performing assets follows:

Mortgage loans are placed on a non-accrual basis when they become 365 days or more past due and are written-down, if necessary, based on the specific evaluation of the collateral underlying the loan. At March 31, 2007, the Group's non-performing mortgage loans totaled \$40.1 million (91.4% of the Group's non-performing loans), a 16.5% increase from the \$34.4 million (89.8% of the Group's non-performing loans) reported at December 31, 2006. Non-performing loans in this category are primarily residential mortgage loans. Based on the value of the underlying collateral, the loan-to-value ratios and credit loss experience, management considers that no significant losses will be incurred on this portfolio.

Commercial loans are placed on non-accrual status when they become 90 days or more past due and are written-down, if necessary, based on the specific evaluation of the underlying collateral, if any. At March 31, 2007, the Group's non-performing commercial loans amounted to \$3.1 million (7.1% of the Group's non-performing loans), a 1.6% decrease from \$3.2 million reported at December 31, 2006 (8.3% of the Group's non-performing loans). Most of this portfolio is collateralized by real estate and no significant losses are expected.

Consumer loans are placed on non-accrual status when they become 90 days past due and written-off when payments are delinquent 120 days in personal loans and 180 days in credit cards and personal lines of credit. At March 31, 2007, the Group's non-performing consumer loans amounted to \$665,000 (1.5% of the Group's total non-performing loans), which decreased from the \$727,000 reported at December 31, 2006 (1.9% of total non-performing loans).

Foreclosed real estate is initially recorded at the lower of the related loan balance or fair value at the date of foreclosure. Any excess of the loan balance over the fair market value of the property is charged against the allowance for loan losses. Subsequently, any excess of the carrying value over the estimated fair market value less disposition cost is charged to operations.

At March 31, 2007, the Group's total liabilities were \$4.954 billion, 22.7% higher than the \$4.037 billion reported at December 31, 2006. Deposits and borrowings, the Group's funding sources, amounted to \$4.892 billion at March 31, 2007, an increase of 21.9% when compared to \$4.015 billion reported at December 31, 2006. At March 31, 2007, borrowings represented 72.6% of interest-bearing liabilities and deposits represented 27.4%, versus 69.4% and 30.6%, respectively, at December 31, 2006.

Borrowings consist mainly of diversified funding sources through the use of repurchase agreements, FHLB advances, subordinated capital notes, term notes, and lines of credit. At March 31, 2007, borrowings amounted to \$3.555 billion, 27.8% greater than the \$2.782 billion at December 31, 2006, mainly due to an increase of 31.0% in repurchase agreements, reflecting the funding needed to finance the Group's investment and loan portfolio.

The FHLB system functions as a source of credit to financial institutions that are members of a regional Federal Home Loan Bank. As a member of the FHLB, the Group can obtain advances from the FHLB, secured by the FHLB stock owned by the Group, as well as by certain of the Group's mortgages and investment securities. FHLB advances totaled \$195.0 million at March 31, 2007, and \$181.9 million at December 31, 2006. The Group has the capacity to expand FHLB funding up to a maximum of \$467.2 million based on the assets pledged by the Group on the FHLB.

At March 31, 2007, deposits reached \$1.338 billion, up 8.5%, compared to the \$1.233 billion reported as of December 31, 2006. Deposits reflected a quarterly increase of 8.6% in certificates of deposits, to \$901.2 million primarily due to an increase in brokered deposits. Savings accounts increased 15.5% to \$307.3 million as of March 31, 2007 from \$266.2 million as of December 31, 2006.

Table of Contents**TABLE 10 LIABILITIES SUMMARY AND COMPOSITION**
(Dollars in thousands)

| | March 31, 2007 | December 31, 2006 | Variance % | March 31, 2006 |
|---|---------------------|-------------------------|---------------|---------------------|
| Deposits: | | | | |
| Non-interest bearing deposits | \$ 52,265 | \$ 59,603 | -12.3% | \$ 58,037 |
| Now accounts | 72,345 | 72,810 | -0.6% | 86,208 |
| Savings accounts | 307,319 | 266,181 | 15.5% | 107,867 |
| Certificates of deposit | 901,026 | 829,867 | 8.6% | 1,014,851 |
| | 1,332,955 | 1,228,461 | 8.5% | 1,266,963 |
| Accrued interest payable | 4,630 | 4,527 | 2.3% | 6,578 |
| | 1,337,585 | 1,232,988 | 8.5% | 1,273,541 |
| Borrowings: | | | | |
| Repurchase agreements | 3,321,105 | 2,535,923 | 31.0% | 2,513,986 |
| Advances from FHLB | 195,000 | 181,900 | 7.2% | 300,000 |
| Subordinated capital notes | 36,083 | 36,083 | 0.0% | 72,166 |
| Term notes | | 15,000 | -100.0% | 15,000 |
| Federal funds purchased and other short term borrowings | 3,139 | 13,568 | -76.9% | 13,811 |
| | 3,555,327 | 2,782,474 | 27.8% | 2,914,963 |
| Total deposits and borrowings | 4,892,912 | 4,015,462 | 21.9% | 4,188,504 |
| Securities purchased but not yet received | 40,067 | | 0.0% | 1,233 |
| Other liabilities | 20,752 | 21,802 | -4.8% | 30,751 |
| Total liabilities | \$ 4,953,731 | \$ 4,037,264 | 22.7% | \$ 4,220,488 |
| Deposits portfolio composition percentages: | | | | |
| Non-interest bearing deposits | 3.9% | 4.9% | | 4.5% |
| Now accounts | 5.4% | 5.9% | | 6.8% |
| Savings accounts | 23.1% | 21.7% | | 8.5% |
| Certificates of deposit | 67.6% | 67.6% | | 80.2% |
| | 100.0% | 100.0% | | 100.0% |
| Borrowings portfolio composition percentages: | | | | |
| Repurchase agreements | 93.4% | 85.7% | | 86.2% |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | | |
|---|---------------|---------------|---------------|
| Advances from FHLB | 5.5% | 11.1% | 10.3% |
| Subordinated capital notes | 1.0% | 2.5% | 2.5% |
| Term notes | 0.0% | 0.5% | 0.5% |
| Federal funds purchased and other short term borrowings | 0.1% | 0.2% | 0.5% |
| | 100.0% | 100.0% | 100.0% |

Repurchase agreements

| | | | |
|--|--------------|--------------|--------------|
| Amount outstanding at quarter-end | \$ 3,321,105 | \$ 2,535,923 | \$ 2,513,986 |
| Daily average outstanding balance | \$ 2,763,159 | \$ 2,627,323 | \$ 2,480,470 |
| Maximum outstanding balance at any month-end | \$ 3,321,105 | \$ 2,923,796 | \$ 2,513,986 |

Stockholders Equity

Stockholders equity as of March 31, 2007 was \$338.3 million, or \$11.04 per share, compared to \$336.4 million as of December 31, 2006, or \$10.98 per share.

On August 30, 2005, the Board of Directors of the Group approved a new stock repurchase program pursuant to which the Group is authorized to purchase in the open market up to \$12.1 million of its outstanding shares of common stock. The program superseded the program established in March 2003. On June 20, 2006, the Board of Directors approved an increase of \$3.0 million to the initial amount, for the repurchase of up to \$15.1 million. The shares of common stock so repurchased are to be held by the Group as treasury shares. No shares were repurchased during the quarter ended March 31, 2007.

The Group's common stock is traded on the New York Stock Exchange (NYSE) under the symbol OFG. At March 31, 2007, the Group's market capitalization for its outstanding common stock was \$288.1 million (\$11.78 per share).

Table of Contents

Under the regulatory framework for prompt corrective action, banks that meet or exceed a Tier I capital risk-based ratio of 6%, a total capital risk-based ratio of 10% and a leverage ratio of 5% are considered well capitalized. The Bank exceeds those regulatory capital requirements.

The following are the consolidated capital ratios of the Group at March 31, 2007 and December 31, 2006:

TABLE 11 CAPITAL, DIVIDENDS AND STOCK DATA

(In thousands, except for per share data)

| | March 31, 2007 | December 31, 2006 | Variance % | March 31, 2006 |
|--|-------------------------------|----------------------------------|-----------------------|-------------------------------|
| Capital data: | | | | |
| Stockholders equity | \$ 338,322 | \$ 336,426 | 0.6% | \$ 343,610 |
| Regulatory Capital Ratios data: | | | | |
| Leverage Capital Ratio | 8.21% | 8.42% | -2.5% | 9.67% |
| Minimum Leverage Capital Ratio Required | 4.00% | 4.00% | | 4.00% |
| Actual Tier 1 Capital | \$ 379,926 | \$ 372,558 | 2.0% | \$ 439,461 |
| Minimum Tier 1 Capital Required | \$ 185,066 | \$ 176,987 | 4.6% | \$ 181,856 |
| Tier 1 Risk-Based Capital Ratio | 19.15% | 21.57% | -11.2% | 33.88% |
| Minimum Tier 1 Risk-Based Capital Ratio Required | 4.00% | 4.00% | | 4.00% |
| Actual Tier 1 Risk-Based Capital | \$ 379,926 | \$ 372,558 | 2.0% | \$ 439,461 |
| Minimum Tier 1 Risk-Based Capital Required | \$ 79,357 | \$ 67,830 | 17.0% | \$ 51,887 |
| Total Risk-Based Capital Ratio | 19.56% | 22.04% | -11.3% | 34.44% |
| Minimum Total Risk-Based Capital Ratio Required | 8.00% | 8.00% | | 8.00% |
| Actual Total Risk-Based Capital | \$ 387,972 | \$ 380,574 | 1.9% | \$ 446,788 |
| Minimum Total Risk-Based Capital Required | \$ 158,713 | \$ 135,677 | 17.0% | \$ 103,774 |
| Stock data: | | | | |
| Outstanding common shares, net of treasury | 24,484 | 24,453 | 0.0% | 24,620 |
| Book value | \$ 11.04 | \$ 10.98 | 0.6% | \$ 11.19 |

Edgar Filing: ORIENTAL FINANCIAL GROUP INC - Form 10-Q

| | | | | |
|-------------------------------|------------|------------|-------|------------|
| Market price at end of period | \$ 11.78 | \$ 12.95 | -9.0% | \$ 14.45 |
| Market capitalization | \$ 288,056 | \$ 316,671 | -9.0% | \$ 355,759 |

| | March 31, 2007 | March 31, 2006 | Variance % |
|-----------------------------------|-------------------------------|---------------------------|-----------------------|
| Common dividend data: | | | |
| Cash dividends declared | \$ 3,427 | \$ 3,448 | -0.6% |
| Cash dividends declared per share | \$ 0.14 | \$ 0.14 | 0.0% |
| Payout ratio | 35.00% | 50.34% | -30.5% |
| Dividend yield | 4.75% | 3.88% | 22.4% |

As of March 31, 2007, December 31, 2006 and March 31, 2006, the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, and institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios set forth in the following table:

| | March 31, 2007 | December 31, 2006 | Variance % |
|---|---------------------------|----------------------------------|-----------------------|
| BANK RATIOS | | | |
| Regulatory Capital Ratios data: | | | |
| Total Tier 1 Capital to Total Assets | 6.51% | 6.43% | 1.2% |
| Actual Tier 1 Capital | \$ 268,133 | \$ 285,323 | -6.0% |
| Minimum Capital Requirement (4%) | \$ 182,908 | \$ 177,495 | 3.0% |
| Minimum to be well capitalized (5%) | \$ 228,635 | \$ 222,098 | 2.9% |
| Tier 1 Capital to Risk-Weighted Average | 15.31% | 17.01% | -10.0% |
| Actual Tier 1 Risk-Based Capital | \$ 297,695 | \$ 285,323 | 4.3% |
| Minimum Capital Requirement (4%) | \$ 77,768 | \$ 67,095 | 15.9% |
| Minimum to be will capitalized (6%) | \$ 116,652 | \$ 100,543 | 16.0% |
| Total Capital to Risk-Weighted Assets | 15.73% | 17.49% | -10.1% |
| Actual Total Risk-Based Capital | \$ 305,741 | \$ 293,339 | 4.2% |
| Minimum Capital Requirement (8%) | \$ 155,537 | \$ 134,174 | 15.9% |
| Minimum to be well capitalized (10%) | \$ 194,421 | \$ 167,651 | 16.0% |

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Interest Rate Risk and Asset/Liability Management**

The Group's interest rate risk and asset/liability management is the responsibility of the ALCO, which is composed of members of the Group's senior management and board of directors. The principal objective of ALCO is to enhance profitability while maintaining an appropriate level of interest rate and liquidity risks. ALCO is also involved in formulating economic projections and strategies used by the Group in its planning and budgeting process. In addition, ALCO oversees the Group's sources, uses and pricing of funds.

Interest rate risk can be defined as the exposure of the Group's operating results or financial position to adverse movements in market interest rates, which mainly occur when assets and liabilities reprice at different times and at different rates. This difference is commonly referred to as a maturity mismatch or gap. The Group employs various techniques to assess its degree of interest rate risk.

The Group is liability sensitive due to its fixed rate and medium to long-term asset composition being funded with shorter-term repricing liabilities. As a result, the Group used various derivative instruments for hedging credit and market risk. The notional amounts are amounts from which calculations and payments are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amount 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 controlled the credit risk of its derivative financial instrument agreements through credit approvals, limits, monitoring procedures and collateral, when considered necessary. As discussed in Item 2 under Overview of financial performance during the December 2006 and March 2007 quarters, the Group restructured a significant part of its repurchase agreement portfolio into longer term structured repurchased agreements, some fixed and others variable, reducing significantly its sensitivity to short-term interest rate repricing. The Group generally used interest rate swaps and interest rate options in managing its interest rate risk exposure. The swaps were entered into to convert 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 monthly or quarterly payment based on LIBOR. Floating rate payments received from the swap counterparties correspond to the floating rate payments made on the short-term borrowings thus resulting in a net fixed rate cost to the Group. Please refer to Note 8-Derivatives Activities of the accompanying unaudited consolidated financial statements for more information related to the Group's swaps, including derivatives used to manage exposure to the stock market on the certificates of deposit with an option tied to the performance of the Standard & Poor's 500 stock market index.

During the quarter ended March 31, 2007 and 2006, gains of \$8.4 million and \$882,000, respectively, were recognized as earnings and reflected as Derivatives in the consolidated statements of income. For the quarter ended March 31, 2006 unrealized gains of \$9.9 million on derivatives designated as cash flow hedges were included in other comprehensive income. The Group previously announced a net gain of approximately \$11 million from the July 2006 unwinding of interest rate swaps that had been used to hedge rising interest costs of short-term repurchase agreements. This gain was included in other comprehensive income, and was being recognized into earnings as a reduction of interest expense on remaining short-term borrowings. The recent repurchase agreement restructuring, however, significantly reduced the Group's short-term borrowings during the December 2006 and March 2007 quarters, eliminating the forecasted transactions the swaps were intended to hedge. As a result, Oriental recognized the remaining balance of \$8.2 million (equal to \$0.33 per diluted share) of the gain as non-interest income in the quarter ended March 31, 2007.

At March 31, 2007 and December 31, 2006, the fair value of derivatives was recognized as either assets or liabilities in the unaudited consolidated statements of financial condition are as follows: the purchased options used to manage the exposure to the stock market on stock indexed deposits represented an asset of \$39.7 million and \$34.2 million, respectively, are presented as other assets and the options sold to customers embedded in the certificates of deposit represented a liability are recorded as deposits amounting \$37.7 million and \$32.2 million, respectively.

The Group is exposed to a reduction in the level of net interest income (NII) in a rising interest rate environment. NII will fluctuate with changes in the levels of interest rates, affecting interest-sensitive assets and liabilities. The hypothetical rate scenarios as of March 31, 2007 and December 31, 2006 consider gradual and parallel changes of plus

and minus 200 basis points during a forecasted twelve-month period. If (1) the rates in effect at year-end remain constant, or increase or decrease on instantaneous and sustained changes in the amounts presented for each forecasted period, and (2) all scheduled repricing, reinvestments and estimated prepayments, and reissuances are constant, or increase or decrease accordingly; NII will fluctuate as shown on the following table:

-33-

Table of Contents

| Change in Interest rate | (Dollars in thousands) | | Percent Change |
|----------------------------|------------------------|------------------|-------------------|
| | Expected NII | Amount Change | |
| March 31, 2007: | | | |
| Base Scenario | | | |
| Flat | \$ 70,720 | \$ | 0.00% |
| + 200 Basis points | \$ 65,242 | \$ (4,959) | -7.06% |
| - 200 Basis points | \$ 75,858 | \$ 5,657 | 8.06% |
| December 31, 2006: | | | |
| Base Scenario | | | |
| Flat | \$ 47,352 | \$ | 0.00% |
| + 200 Basis points | \$ 30,999 | \$ (16,354) | -34.54% |
| - 100 Basis points | \$ 66,541 | \$ 19,189 | 40.52% |

Liquidity Risk Management

The objective of the Group's asset and liability management function is to maintain consistent growth in net interest income within the Group's policy limits. This objective is accomplished through management of the Group's balance sheet composition, liquidity, and interest rate risk exposure arising from changing economic conditions, interest rates and customer preferences.

The goal of liquidity management is to provide adequate funds to meet changes in loan demand or unexpected deposit withdrawals. This is accomplished by maintaining liquid assets in the form of investment securities, maintaining sufficient unused borrowing capacity in the national money markets and delivering consistent growth in core deposits. As of March 31, 2007, the Group had approximately \$169.8 million in investments available to cover liquidity needs. Additional asset-driven liquidity is provided by securitizable loan assets. These sources, in addition to the Group's 8.21% average equity capital base, provide a stable funding base.

In addition to core deposit funding, the Bank also accesses a variety of other short-term and long-term funding sources. Short-term funding sources mainly include securities sold under agreements to repurchase. Borrowing funding source limits are determined annually by each counterparty and depend on the Bank's financial condition and delivery of acceptable collateral securities. The Bank may be required to provide additional collateral based on the fair value of the underlying securities. The Group also uses the FHLB as a funding source, issuing notes payable, such as advances, through its FHLB member subsidiary, the Bank. This funding source requires the Bank to maintain a minimum amount of qualifying collateral with a fair value of at least 110% of the outstanding advances. At March 31, 2007, the Group has an additional borrowing capacity with the FHLB of \$467.2 million.

In addition, the Bank utilizes the National Certificate of Deposit (CD) Market as a source of cost effective deposit funding in addition to local market deposit inflows. Depositors in this market consist of credit unions, banking institutions, CD brokers and some private corporations or non-profit organizations. The Bank's ability to acquire brokered deposits can be restricted if it becomes in the future less than well capitalized. An adequately-capitalized bank, by regulation, may not accept deposits from brokers unless it applies for and receives a waiver from the FDIC. As of March 31, 2007, the Bank had line of credit agreement with other financial institutions permitting the Bank to borrow a maximum aggregate amount of \$15.0 million (no borrowings were made during the three-month period ended March 31, 2007 under such lines of credit). The agreements provide for unsecured advances to be used by the

Group on an overnight basis. Interest rates are negotiated at the time of the transaction. The credit agreements are renewable annually.

The Group's liquidity targets are reviewed monthly by ALCO and are based on the Group's commitment to make loans and investments and its ability to generate funds.

The principal source of funds for the Group is dividends from the Bank. The ability of the Bank to pay dividends is restricted by regulatory authorities (see "Dividend Restrictions" under "Regulation and Supervision" in Item 1 in the Group's annual report on form 10-K for the fiscal year December 31, 2006). Primarily, through such dividends the Group meets its cash obligations and pays dividends to its common and preferred stockholders. Management believes that the Group will continue to meet its cash obligations as they become due and pay dividends as they are declared.

-34-

Table of Contents

Changes in statutes and regulations, including tax laws and rules

The Group, as a Puerto Rico-chartered financial holding company, and its subsidiaries, are each subject to extensive federal and local governmental supervision and regulation relating to its banking, securities, and insurance business. The Group also benefits from favorable tax treatment under regulations relating to the activities of its international banking entities. In addition, there are laws and other regulations that restrict transactions between the Group and its subsidiaries. Any change in such tax or other regulations, whether by applicable regulators or as a result of legislation subsequently enacted by the Congress of the United States or the Legislature of Puerto Rico, could have an effect on the Group's results of operations and financial condition.

Puerto Rico international banking entities, or IBEs, are currently exempt from taxation under Puerto Rico law. The IBE Act, as amended, imposes income taxes at normal statutory rates on each IBE that operates as a unit of a bank if the IBE's net income exceeds 20 percent of the bank's net income in taxable years commencing on July 1, 2005 and thereafter. It does not impose income taxation on an IBE that operates as a subsidiary of a bank.

The Group has an IBE that operates as a unit of the Bank. In November 2003, the Group organized a new IBE that operates as a subsidiary of the Bank. The Bank transferred as of January 1, 2004, substantially all of the Bank's IBE assets to the new IBE subsidiary. Although this transfer of IBE assets allows the Group to continue enjoying tax benefits, there cannot be any assurance that the IBE Act will not be modified in the future in a manner to reduce the tax benefits available to the IBE subsidiary.

On August 1, 2005 the Puerto Rico Legislature approved Act No. 41, known as the Act for the Educational Future of the Puerto Rican Children. This law imposes an additional tax of 2.5% on taxable net income. This law is applicable to all corporations and partnerships with a taxable net income over \$20,000, according to part (a) of Section 1015 of the Puerto Rico Internal Revenue Code of 1994, as amended. The law is effective for tax years beginning after December 31, 2004 and ending on or before December 31, 2006. Although the effectiveness of this law was subject to the final approval of the Legislature's Joint Resolution No. 445, concerning the Commonwealth's General Budget of the 2005-2006 fiscal year, which Joint Resolution was vetoed by the Puerto Rico Governor, the Puerto Rico Treasury Department has taken the position that the law is in effect.

Table of Contents

On May 13, 2006, the Puerto Rico Governor signed into law Act No. 89, which amends the Puerto Rico Internal Revenue Code of 1994, as amended, to impose an additional tax of 2% on the taxable income exceeding \$20,000 of banking corporations covered under the Puerto Rico Banking Act of 1933, as amended. The law is effective for taxable years beginning after December 31, 2005 and ending on or before December 31, 2006. This additional tax imposition did not have a material effect on the Group's consolidated operational results due to the tax exempt composition of the Group's investments.

On May 16, 2006, the Puerto Rico Governor also signed into law Act No. 98 to impose a one-time extraordinary tax on the net available income of non-exempt corporations and partnerships for the last taxable year ended on or before December 31, 2005. This extraordinary tax constitutes, in effect, a prepayment, as the taxpayer will be allowed to credit the amount so paid against its Puerto Rico income tax liability for taxable years beginning after December 31, 2005; any unused credit can be claimed by the taxpayer in four equal installments, beginning on the taxable year following that in which the extraordinary tax is paid. This additional tax imposition did not have a material effect on the Group's consolidated operational results due to the tax exempt composition of the Group's investments.

Item 4. CONTROLS AND PROCEDURES**Disclosure Controls and Procedures**

As of the end of the period covered by this quarterly report on Form 10-Q, an evaluation was carried out under the supervision and with the participation of the Group's management, including the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), of the effectiveness of the design and operation of the Group's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based upon such evaluation, the CEO and the CFO have concluded that, as of the end of such period, the Group's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Group in the reports that it files or submits under the Exchange Act.

Internal Control over Financial Reporting

There were no changes in the Group's internal control over financial reporting (as such term is defined on rules 13-a-15(e) and 15d-15(e) under the Exchange Act) during the quarter ended March 31, 2007.

PART II OTHER INFORMATION**Item 1. LEGAL PROCEEDINGS**

On August 14, 1998, as a result of a review of its accounts in connection with the admission by a former Group officer of having embezzled funds and manipulated bank accounts and records, the Group became aware of certain irregularities. The Group notified the appropriate regulatory authorities and commenced an intensive investigation with the assistance of forensic accountants, fraud experts, and legal counsel. The investigation determined losses of \$9.6 million, resulting from dishonest and fraudulent acts and omissions involving several former Group employees. These losses were submitted to the Group's fidelity insurance policy (the Policy) issued by Federal Insurance Company, Inc. (FIC). In the opinion of the Group's management, its legal counsel and experts, the losses determined by the investigation were covered by the Policy. However, FIC denied all claims for such losses. On August 11, 2000, the Group filed a lawsuit in the United States District Court for the District of Puerto Rico against FIC, a stock insurance corporation organized under the laws of the State of Indiana, for breach of insurance contract, breach of covenant of good faith and fair dealing and damages, seeking payment of the Group's \$9.6 million insurance claim loss and the payment of consequential damages of no less than \$13.0 million resulting from FIC capricious, arbitrary fraudulent and without cause denial of the Group's claim. The losses resulting from such dishonest and fraudulent acts and omissions were expensed in prior years. On October 3, 2005, a jury rendered a verdict of \$7.5 million in favor of the Group and against FIC, the defendant. The jury granted the Group \$453,219 for fraud and loss documentation in connection with its Accounts Receivable Returned Checks Account. However, the jury could not reach a decision on the Group's claim for \$3.4 million in connection with fraud in its Cash Accounts, thus forcing a new trial on this issue. The jury denied the Group's claim for \$5.6 million in connection with fraud in the Mortgage Loans Account, but the jury determined that FIC had acted in bad faith and with malice. It, therefore, awarded the Group \$7.1 million in consequential damages. The court decided not to enter a final judgment for the aforementioned awards until a new trial on the fraud in the Cash Accounts claim is held. After a final judgment is entered, the parties would be entitled to exhaust their post-judgment and appellate rights. The Group has not recognized any income on this claim since the

appellate rights have

Table of Contents

not been exhausted and the amount to be collected has not been determined. The Group expects to request and recover prejudgment interest, costs, fees and expenses related to its prosecution of this case. However, no specific sum can be anticipated as they are subject to the discretion of the court. The court has scheduled this new trial for June 25, 2007. In addition, the Group and its subsidiaries are defendants in a number of legal proceedings incidental to their business. The Group is vigorously contesting such claims. Based upon a review by legal counsel and the development of these matters to date, management is of the opinion that the ultimate aggregate liability, if any, resulting from these claims will not have a material adverse effect on the Group's financial condition or results of operations.

Item 1A. RISK FACTORS

There have been no material changes to the risk factors as previously disclosed under Item 1A to Part 1 of the Group's Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

- a) None
- b) Not applicable
- c) None

Item 3. DEFAULTS UPON SENIOR SECURITIES

None

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None

Item 5. OTHER INFORMATION

- a) None
- b) None

Item 6. EXHIBITS

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

-37-

Table of Contents

Signatures

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

ORIENTAL FINANCIAL GROUP INC.
(Registrant)

By: /s/ José Rafael Fernández

Dated: May 10, 2007

José Rafael Fernández
President and Chief Executive Officer

By: /s/ Norberto González

Dated: May 10, 2007

Norberto González
Executive Vice President and Chief Financial
Officer

-38-