

OFG BANCORP
Form 10-Q
August 09, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

or

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

For the transition period from _____ to _____

Commission File Number 001-12647

OFG Bancorp

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

Principal Executive Offices:

254 Muñoz Rivera Avenue

San Juan, Puerto Rico 00918

Telephone Number: (787) 771-6800

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

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

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

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

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

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

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

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION	Page
Item 1.	
Financial Statements	
Unaudited Consolidated Statements of Financial Condition	1
Unaudited Consolidated Statements of Operations	2
Unaudited Consolidated Statements of Comprehensive Income	3
Unaudited Consolidated Statements of Changes in Stockholders' Equity	4
Unaudited Consolidated Statements of Cash Flows	5
Notes to Unaudited Consolidated Financial Statements	
Note 1– Organization, Consolidation and Basis of Presentation	7
Note 2 – Business Combinations	10
Note 3 – Securities Purchased Under Agreements to Resell and Investments	13
Note 4 – Loans	19
Note 5 – Allowance for Loan and Lease Losses	26
Note 6 – Premises and Equipment	38
Note 7 – Derivative Activities	39
Note 8 – Accrued Interests Receivable and Other Assets	41
Note 9 – Deposits and Related Interests	42
Note 10 – Borrowings	43
Note 11 – Related Party Transactions	46
Note 12 – Income Taxes	47
Note 13 – Stockholders' Equity and Earnings per Common Share	48
Note 14 – Commitments	53
Note 15 – Contingencies	55
Note 16 – Fair Value of Financial Instruments	55
Note 17 – Offsetting Arrangements	64
Note 18 – Business Segments	66
Note 19 – Subsequent Events	68
Item 2.	
Management's Discussion and Analysis of Financial Condition and Results of Operations	
Critical Accounting Policies and Estimates	69
Overview of Financial Performance	70
Selected Financial Data	70
Analysis of Results of Operations	78
Analysis of Financial Condition	87
Item 3.	108
Quantitative and Qualitative Disclosures about Market Risk	
Item 4.	112
Control and Procedures	
PART II – OTHER INFORMATION	

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Item 1.	Legal Proceedings	113
Item 1A.	Risk Factors	113
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	113
Item 3.	Default upon Senior Securities	113
Item 4.	Mine Safety Disclosures	113
Item 5.	Other Information	113
Item 6.	Exhibits	113
SIGNATURES		114
EXHIBIT INDEX		

FORWARD-LOOKING STATEMENTS

The information included in this quarterly report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may relate to the financial condition, results of operations, plans, objectives, future performance and business of OFG Bancorp, formerly known as Oriental Financial Group Inc. (“we,” “our,” “us” or the “Company”), including, but not limited to, statements with respect to the adequacy of the allowance for loan losses, delinquency trends, market risk and the impact of interest rate changes, capital markets conditions, capital adequacy and liquidity, and the effect of legal proceedings and new accounting standards on the Company’s financial condition and results of operations. All statements contained herein that are not clearly historical in nature are forward-looking, and the words “anticipate,” “believe,” “continue,” “expect,” “estimate,” “intend,” “project” and similar expressions and future or conditional verbs such as “will,” “would,” “should,” “could,” “might,” “can,” “may,” or similar expressions are generally intended to identify forward-looking statements.

These statements are not guarantees of future performance and involve certain risks, uncertainties, estimates and assumptions by management that are difficult to predict. Various factors, some of which by their nature are beyond the Company’s control, could cause actual results to differ materially from those expressed in, or implied by, such forward-looking statements. Factors that might cause such a difference include, but are not limited to:

- the rate of growth in the economy and employment levels, as well as general business and economic conditions;
- changes in interest rates, as well as the magnitude of such changes;
- the fiscal and monetary policies of the federal government and its agencies;
- a credit default by the U.S. or Puerto Rico governments or a downgrade in the credit ratings of the U.S. or Puerto Rico governments;
- changes in federal bank regulatory and supervisory policies, including required levels of capital;
- the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) on the Company’s businesses, business practices and cost of operations;
- the relative strength or weakness of the consumer and commercial credit sectors and of the real estate market in Puerto Rico;
- the performance of the stock and bond markets;
- competition in the financial services industry;
- additional Federal Deposit Insurance Corporation (“FDIC”) assessments;

- possible legislative, tax or regulatory changes; and
- difficulties in integrating the acquired Puerto Rico operations of Banco Bilbao Vizcaya Argentaria, S. A. (“BBVAPR”) into the Company’s operations.

Other possible events or factors that could cause results or performance to differ materially from those expressed in these forward-looking statements include the following: negative economic conditions that adversely affect the general economy, housing prices, the job market, consumer confidence and spending habits which may affect, among other things, the level of non-performing assets, charge-offs and provision expense; changes in interest rates and market liquidity which may reduce interest margins, impact funding sources and affect the ability to originate and distribute financial products in the primary and secondary markets; adverse movements and volatility in debt and equity capital markets; changes in market rates and prices which may adversely impact the value of financial assets and liabilities; liabilities resulting from litigation and regulatory investigations; changes in accounting standards, rules and interpretations; increased competition; the Company’s ability to grow its core businesses; decisions to downsize, sell or close units or otherwise change the Company’s business mix; and management’s ability to identify and manage these and other risks.

All forward-looking statements included in this quarterly report on Form 10-Q are based upon information available to the Company as of the date of this report, and other than as required by law, including the requirements of applicable securities laws, the Company assumes no obligation to update or revise any such forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

Item 1. Financial Statements

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

AS OF JUNE 30, 2013 AND DECEMBER 31, 2012

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

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

See notes to unaudited consolidated financial statements.

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

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

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

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

See notes to unaudited consolidated financial statements.

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UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE QUARTERS AND SIX-MONTHS PERIODS ENDED JUNE 30, 2013 AND 2012

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

See notes to unaudited consolidated financial statements.

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UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2013 AND 2012

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

See notes to unaudited consolidated financial statements.

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX-MONTH PERIODS ENDED JUNE 30, 2013 AND 2012

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

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

OFG BANCORP

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)

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

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

See notes to unaudited consolidated financial statements

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – ORGANIZATION, CONSOLIDATION AND BASIS OF PRESENTATION

Nature of Operations

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

On December 18, 2012, the Company purchased from Banco Bilbao Vizcaya Argentaria, S. A. (“BBVA”), all of the outstanding common stock of each of (i) BBVAPR Holding Corporation (“BBVAPR Holding”), the sole shareholder of Banco Bilbao Vizcaya Argentaria Puerto Rico (“BBVAPR Bank”), a Puerto Rico chartered commercial bank, and BBVA Seguros, Inc. (“BBVA Seguros”), an insurance agency, and (ii) BBVA Securities of Puerto Rico, Inc. (“BBVA Securities,” now known as “OFS Securities”), a registered broker-dealer. This transaction is referred to as the BBVAPR Acquisition” and BBVAPR Holding, BBVAPR Bank, BBVA Seguros and BBVA Securities are collectively referred to as the “BBVAPR Companies” or “BBVAPR.”

Basis of Presentation and Use of Estimates

The accounting and reporting policies of the Company conform with U.S. generally accepted accounting principles (“GAAP”) and to banking industry practices.

The unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial information and should be read in conjunction with the audited consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2012 (“2012 Form 10-K”). All significant intercompany balances and transactions have been eliminated in consolidation. These unaudited statements are, in the opinion of management, a fair statement of the results for the periods reported and include all necessary adjustments, all of a normal recurring nature, for a fair statement of such results. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to SEC rules and regulations. Management believes that the disclosures made are adequate to make the information presented not misleading. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts

reported in the unaudited consolidated financial statements and related disclosures. These estimates are based on information available as of the date of the consolidated financial statements. While management makes its best judgment, actual amounts or results could differ from these estimates. Interim period results are not necessarily indicative of the results to be expected for the full year.

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

Significant Accounting Policies

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

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

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

Offsetting Financial Assets and Liabilities - In December 2011, the FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. The ASU is intended to enhance current disclosure requirements on offsetting financial assets and liabilities. The new disclosures enable financial statement users to compare balance sheets prepared under GAAP and IFRS, which are subject to different offsetting models. The guidance requires disclosure of both gross and net information about instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. The disclosures are required irrespective of whether such instruments are presented gross or net on the balance sheet. In January 2013, the FASB issued ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, which clarify that the scope of this guidance applies to derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amended guidance was effective for annual and

interim reporting periods beginning on or after January 1, 2013, with comparative retrospective disclosures required for all periods presented. We adopted the guidance in the first quarter of 2013. Our adoption of the guidance had no effect on our financial condition, results of operations or liquidity since it only impacts disclosures only. The new disclosures required by the amended guidance are included in “Note 17 – Offsetting Arrangements” hereto.

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Future Application of Accounting Standards

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 2 – BUSINESS COMBINATIONS***BBVAPR Acquisition***

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

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

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

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

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

10

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Merger and Restructuring Charges

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

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

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

Restructuring Reserve

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

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

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The FDIC-Assisted Acquisition and FDIC Shared-Loss Indemnification Asset

On April 30, 2010, the Bank acquired certain assets and assumed certain deposits and other liabilities in the FDIC-assisted acquisition of Eurobank. These assets acquired and liabilities assumed were recorded at fair value on the date of acquisition. As part of the Purchase and Assumption Agreement between the Bank and the FDIC (the “Purchase and Assumption Agreement”), the Bank and the FDIC entered into shared-loss agreements, whereby the FDIC covers a substantial portion of any losses on loans (and related unfunded loan commitments), foreclosed real estate and other repossessed properties.

The acquired loans, foreclosed real estate, and other repossessed property subject to the shared-loss agreements are collectively referred to as “covered assets.” Under the terms of the shared-loss agreements, the FDIC absorbs 80% of losses and shares in 80% of loss recoveries on covered assets. The term of the shared-loss agreement covering single family residential mortgage loans is ten years with respect to losses and loss recoveries, while the term of the shared-loss agreement covering commercial loans is five years with respect to losses and eight years with respect to loss recoveries, from the April 30, 2010 acquisition date. The shared-loss agreements also provide for certain costs directly related to the collection and preservation of covered assets to be reimbursed at an 80% level. The indemnification asset represents the portion of estimated losses covered by the shared-loss agreements between the Bank and the FDIC.

The Bank agreed to make a true-up payment, also known as clawback liability, to the FDIC on the date that is 45 days following the last day (such day, the “True-Up Measurement Date”) of the final shared-loss month, or upon the final disposition of all covered assets under the shared-loss agreements in the event losses thereunder fail to reach expected levels. Under the shared-loss agreements, the Bank will pay to the FDIC 50% of the excess, if any, of: (i) 20% of the Intrinsic Loss Estimate of \$906.0 million (or \$181.2 million) (as determined by the FDIC) less (ii) the sum of: (A) 25% of the asset discount (per bid) (or \$227.5 million); plus (B) 25% of the cumulative shared-loss payments (defined as the aggregate of all of the payments made or payable to the Bank minus the aggregate of all of the payments made or payable to the FDIC); plus (C) the sum of the period servicing amounts for every consecutive twelve-month period prior to and ending on the True-Up Measurement Date in respect of each of the shared-loss agreements during which the shared-loss provisions of the applicable shared-loss agreement is in effect (defined as the product of the simple average of the principal amount of shared-loss loans and shared-loss assets at the beginning and end of such period times 1%). The true-up payment represents an estimated liability of \$16.9 million and \$15.5 million, net of discount, as of June 30, 2013 and December 31, 2012, respectively. This estimated liability is accounted for as a reduction of the indemnification asset.

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

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 3 – SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL AND INVESTMENTS

Money Market Investments

The Company considers as cash equivalents all money market instruments that are not pledged and that have maturities of three months or less at the date of acquisition. At June 30, 2013 and December 31, 2012, money market instruments included as part of cash and cash equivalents amounted to \$11.0 million and \$13.2 million, respectively.

Securities Purchased Under Agreements to Resell

Securities purchased under agreements to resell consist of short-term investments and are carried at the amounts at which the assets will be subsequently resold as specified in the respective agreements. At December 31, 2012, securities purchased under agreements to resell amounted to \$80.0 million. The fair value of the collateral securities held by the Company on these transactions as of December 31, 2012 was approximately \$82.1 million. On June 30, 2013 the Company had no securities purchased under agreements to resell.

Investment Securities

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

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

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

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

<u>Description</u>	Sale Price	Six-Month period Ended June 30, 2012		
		Book Value at Sale	Gross Gains	Gross Losses
(In thousands)				
Sale of securities available-for-sale				
Mortgage-backed securities and CMOs				
FNMA and FHLMC certificates	\$ 367,971	\$ 349,400	\$ 18,581	\$ -
GNMA certificates	39,484	39,483	1	-
CMOs issued by US Government sponsored agencies	19,725	18,372	1,353	-
Total mortgage-backed securities and CMOs	427,180	407,255	19,935	-
Investment securities				
Obligations of U.S. Government sponsored agencies	80,000	80,000	-	-
Obligations of Puerto Rico Government and political subdivisions	35,882	36,478	31	628
Structured credit investments	10,530	10,530	-	-
Total investment securities	126,412	127,008	31	628
Total	\$ 553,592	\$ 534,263	\$ 19,966	\$ 628

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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The following tables show the Company's gross unrealized losses and fair value of investment securities available-for-sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2013 and December 31, 2012:

	Amortized Cost	June 30, 2013 12 months or more Unrealized Loss (In thousands)	Fair Value
Securities available-for-sale			
Obligations of Puerto Rico Government and political subdivisions	\$ 1,712	61	1,651
CMOs issued by US Government sponsored agencies	2,094	171	1,923
	\$ 3,806	\$ 232	\$ 3,574

	Amortized Cost	Less than 12 months Unrealized Loss (In thousands)	Fair Value
Securities available-for-sale			
Obligations of Puerto Rico Government and political subdivisions	\$ 20,588	\$ 1,233	\$ 19,355
CMOs issued by US Government sponsored agencies	203,524	2,357	201,167
FNMA and FHLMC certificates	219,983	4,324	215,659
GNMA certificates	206	13	193
	\$ 444,301	\$ 7,927	\$ 436,374

	Amortized Cost	Total Unrealized Loss (In thousands)	Fair Value
Securities available-for-sale			
Obligations of Puerto Rico Government and political subdivisions	\$ 22,300	\$ 1,294	\$ 21,006
CMOs issued by US Government sponsored agencies	205,618	2,528	203,090
FNMA and FHLMC certificates	219,983	4,324	215,659
GNMA certificates	206	13	193
	\$ 448,107	\$ 8,159	\$ 439,948

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

	Amortized Cost	December 31, 2012 12 months or more Unrealized Loss (In thousands)		Fair Value
Securities available-for-sale				
Obligations of Puerto Rico Government and political subdivisions	\$ 1,673	\$ 12	\$	1,661
CMOs issued by US Government sponsored agencies	2,194	178		2,016
	\$ 3,867	\$ 190	\$	3,677
	Amortized Cost	Less than 12 months Unrealized Loss (In thousands)		Fair Value
Securities available-for-sale				
Obligations of Puerto Rico Government and political subdivisions	\$ 19,086	\$ 426	\$	18,660
CMOs issued by US Government sponsored agencies	10,671	615		10,056
US Treasury Securities	11,498	2		11,496
GNMA certificates	84	8		76
FNMA and FHLMC certificates	68	1		67
	\$ 41,407	\$ 1,052	\$	40,355
	Amortized Cost	Total Unrealized Loss (In thousands)		Fair Value
Securities available-for-sale				
Obligations of Puerto Rico Government and political subdivisions	\$ 20,759	\$ 438	\$	20,321
CMOs issued by US Government sponsored agencies	12,865	793		12,072
US Treasury Securities	11,498	2		11,496
GNMA certificates	84	8		76
FNMA and FHLMC certificates	68	1		67
	\$ 45,274	\$ 1,242	\$	44,032

The Company conducts quarterly reviews to identify and evaluate each investment in an unrealized loss position for other-than-temporary impairment. Any portion of a decline in value associated with credit loss is recognized in income with the remaining noncredit-related component recognized in other comprehensive income. A credit loss is determined by assessing whether the amortized cost basis of the security will be recovered by comparing the present value of cash flows expected to be collected from the security, discounted at the rate equal to the yield used to accrete current and prospective beneficial interest for the security. The shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis is considered to be the "credit loss."

Other-than-temporary impairment analysis is based on estimates that depend on market conditions and are subject to further change over time. In addition, while the Company believes that the methodology used to value these exposures is reasonable, the methodology is subject to continuing refinement, including those made as a result of market developments. Consequently, it is reasonably possible that changes in estimates or conditions could result in the need to recognize additional other-than-temporary impairment charges in the future.

Securities in an unrealized loss position at June 30, 2013 are mainly composed of highly liquid securities that in most cases have a large and efficient secondary market. Valuations are performed on a monthly basis. The Company's management believes that the unrealized losses of such securities at June 30, 2013 are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuer or guarantor. At June 30, 2013, the Company does not have the intent to sell these investments in an unrealized loss position.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 4 - LOANS

The Company's loan portfolio is composed of covered loans and non-covered loans. The Company presents loans subject to the loss sharing agreements as "covered loans" in the information below, and loans that are not subject to FDIC loss sharing agreements as "non-covered loans." The risks of the Eurobank FDIC-assisted acquisition acquired loans are significantly different from those loans not covered under the FDIC loss sharing agreements because of the loss protection provided by the FDIC. Also, loans acquired in the BBVAPR Acquisition are included as non-covered loans in the unaudited consolidated statements of financial condition. Non-covered loans are further segregated between originated loans, acquired loans accounted for under ASC 310-20 (loans with revolving feature and/or acquired at a premium) and acquired loans accounted for under ASC 310-30 (loans acquired with deteriorated credit quality, including those by analogy).

For a summary of the accounting policy related to loans, interest recognition and allowance for loan and lease losses, please refer to the summary of significant accounting policies included in Note 1 of our 2012 Form 10-K under "Notes to Consolidated Financial Statements".

The composition of the Company's loan portfolio at June 30, 2013 and December 31, 2012 was as follows:

	June 30, 2013	December 31, 2012
	(In thousands)	
Loans not covered under shared-loss agreements with FDIC:		
Originated and other loans and leases held for investment:		
Mortgage	\$ 755,298	\$ 804,942
Commercial	702,074	353,930
Auto and leasing	233,092	50,720
Consumer	89,608	48,136
	1,780,072	1,257,728
Acquired loans:		
Accounted for under ASC 310-20 (Loans with revolving feature and/or		
acquired at a premium)		
Commercial	140,234	317,244
Commercial secured by real estate	14,519	29,215
Auto	373,587	457,894
Consumer	62,751	68,878
	591,091	873,231

Accounted for under ASC 310-30 (Loans acquired with deteriorated credit quality, including those by analogy)			
Commercial		747,077	942,267
Construction		140,060	196,692
Mortgage		781,389	810,135
Auto		462,691	554,938
Consumer		88,375	118,171
		2,219,592	2,622,203
		4,590,755	4,753,162
Deferred loan fees, net		(831)	(3,463)
Loans receivable		4,589,924	4,749,699
Allowance for loan and lease losses on non-covered loans		(46,625)	(39,921)
Loans receivable, net		4,543,299	4,709,778
Mortgage loans held-for-sale		78,350	64,145
Total loans not covered under shared-loss agreements with FDIC, net		4,621,649	4,773,923
Loans covered under shared-loss agreements with FDIC:			
Loans secured by 1-4 family residential properties		123,507	128,811
Construction and development secured by 1-4 family residential properties		16,478	15,969
Commercial and other construction		275,489	289,070
Leasing		943	7,088
Consumer		6,955	8,493
Total loans covered under shared-loss agreements with FDIC		423,372	449,431
Allowance for loan and lease losses on covered loans		(53,992)	(54,124)
Total loans covered under shared-loss agreements with FDIC, net		369,380	395,307
Total loans, net		\$ 4,991,029	\$ 5,169,230

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

*Non-covered Loans*Originated and Other Loans and Leases Held for Investment

The Company's originated and other held for investment loan transactions are encompassed within four portfolio segments: mortgage, commercial, consumer, and auto and leasing.

The following table presents the aging of the recorded investment in gross originated and other loans held for investment as of June 30, 2013 and December 31, 2012 by class of loans. Mortgage loans past due included delinquent loans in the GNMA buy-back option program. Servicers of loans underlying GNMA mortgage-backed securities must report as their own assets the defaulted loans that they have the option (but not the obligation) to repurchase, even when they elect not to exercise that option.

	June 30, 2013						Total Loans	Loans 90+ Days Past Due and Still Accruing
	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due (In thousands)	Current			
Mortgage								
Traditional (by origination year):								
Up to the year 2002	\$ -	\$ 2,937	\$ 6,993	\$ 9,930	\$ 79,666	\$ 89,596	\$ 6	
Years 2003 and 2004	-	5,413	3,429	8,842	117,754	126,596	-	
Year 2005	-	2,136	1,431	3,567	65,196	68,763	-	
Year 2006	-	3,369	2,838	6,207	87,614	93,821	-	
Years 2007, 2008	-	2,863	3,407	6,270	104,169	110,439	433	
and 2009								

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Years 2010, 2011, 2012	-	391	2,115	2,506	96,270	98,776	76
and 2013	-	17,109	20,213	37,322	550,669	587,991	515
Non-traditional Loss mitigation program	-	1,520	2,212	3,732	42,695	46,427	-
	-	4,993	14,287	19,280	68,335	87,615	1,606
	-	23,622	36,712	60,334	661,699	722,033	2,121
Home equity secured personal loans	-	-	12	12	740	752	-
GNMA's buy-back option program	-	-	32,513	32,513	-	32,513	-
	-	23,622	69,237	92,859	662,439	755,298	2,121
Commercial							
Commercial secured by real estate	11,033	1,381	12,694	25,108	386,236	411,344	-
Other commercial and industrial	324	66	753	1,143	289,587	290,730	-
	11,357	1,447	13,447	26,251	675,823	702,074	-
Consumer	670	165	370	1,205	88,403	89,608	-
Auto and leasing	8,826	2,075	1,096	11,997	221,095	233,092	-
Total	\$ 20,853	\$ 27,309	\$ 84,150	\$ 132,312	\$ 1,647,760	\$ 1,780,072	\$ 2,121

20

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

December 31, 2012

	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due (In thousands)	Current	Total Loans	Loans 90+ Days Past Due and Still Accruing
Mortgage							
Traditional							
(by origination year):							
Up to the year 2002	\$ 6,906	\$ 2,116	\$ 11,363	\$ 20,385	\$ 80,883	\$ 101,268	\$ -
Years 2003 and 2004	12,048	5,206	18,162	35,416	114,446	149,862	-
Year 2005	4,983	1,746	8,860	15,589	65,312	80,901	-
Year 2006	9,153	3,525	15,363	28,041	85,045	113,086	-
Years 2007, 2008	2,632	1,682	8,965	13,279	108,358	121,637	-
and 2009							
Years 2010, 2011 and 2012	632	769	1,162	2,563	64,084	66,647	-
and 2012	36,354	15,044	63,875	115,273	518,128	633,401	-
Non-traditional	2,850	1,067	11,160	15,077	42,742	57,819	-
Loss mitigation program	8,933	4,649	19,989	33,571	53,739	87,310	-
	48,137	20,760	95,024	163,921	614,609	778,530	-
Home equity secured personal loans	-	-	10	10	726	736	-
GNMA's buy-back option program	-	-	25,676	25,676	-	25,676	-
	48,137	20,760	120,710	189,607	615,335	804,942	-
Commercial							
	9,062	271	15,335	24,668	226,606	251,274	-

Commercial secured by real estate								
Other commercial and industrial	345	189	2,378	2,912	99,744	102,656	-	
	9,407	460	17,713	27,580	326,350	353,930	-	
Consumer	747	92	409	1,248	46,888	48,136	-	
Auto and leasing	251	129	131	511	50,209	50,720	-	
Total	\$ 58,542	\$ 21,441	\$ 138,963	\$ 218,946	\$ 1,038,782	\$ 1,257,728	\$	-

During the quarter ended June 30, 2013, the Company transferred \$55.0 million of non-performing residential mortgage loans held-for-investment to held-for-sale at a fair value of \$27.0 million. The difference between fair value and book value was recorded as charge-off to the mortgage portfolio. The provision for loan and lease losses during the quarter and six-month period ended June 30, 2013 increased to provide the coverage necessary under the allowance policy for the remaining mortgage loans, following the effects that the aforementioned reclassification had on the mortgage portfolio allowance level.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Acquired Loans Accounted for under ASC 310-20 (Loans with revolving feature and/or acquired at a premium)

Credit cards, retail and commercial revolving lines of credits, floor plans and performing auto loans with FICO scores over 660 acquired at a premium as part of the BBVAPR Acquisition are accounted for under the guidance of ASC 310-20, which requires that any contractually required loan payment receivable in excess of the Company's initial investment in the loans be accreted into interest income on a level-yield basis over the life of the loan. Loans accounted for under ASC 310-20 are placed on non-accrual status when past due in accordance with the Company's non-accrual policy and any accretion of discount or amortization of premium is discontinued. Loans acquired in the BBVAPR Acquisition that were accounted for under the provisions of ASC 310-20, which had fully amortized their premium or discount, recorded at the date of acquisition, are removed from the acquired loan category at the end of the reporting period.

The following table presents the aging of the recorded investment in gross acquired loans accounted for under ASC 310-20 as of June 30, 2013 and December 31, 2012 by class of loans:

	June 30, 2013					Total Loans	Loans 90+ Days Past Due and Still Accruing
	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current		
	(In thousands)						
Commercial	\$ 291	\$ 134	\$ 493	\$ 918	\$ 139,316	\$ 140,234	\$ -
Commercial secured by real estate	9	-	-	9	14,510	14,519	-
Auto	8,849	1,892	674	11,415	362,172	373,587	-
Consumer	1,767	7	1,069	2,843	59,908	62,751	-
Total	\$ 10,916	\$ 2,033	\$ 2,236	\$ 15,185	\$ 575,906	\$ 591,091	\$ -

December 31, 2012

Loans
90+

	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current	Total Loans	Days Past Due and Still Accruing
	(In thousands)						
Commercial	\$ 715	\$ 76	\$ 193	\$ 984	\$ 316,260	\$ 317,244	\$ -
Commercial secured by real estate	315	-	-	315	28,900	29,215	-
Auto	6,753	1,023	275	8,051	449,843	457,894	-
Consumer	982	-	1,095	2,077	66,801	68,878	-
Total	\$ 8,765	\$ 1,099	\$ 1,563	\$ 11,427	\$ 861,804	\$ 873,231	\$ -

22

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Acquired Loans Accounted for under ASC 310-30 (including those accounted for under ASC 310-30 by analogy)

Loans acquired as part of the BBVAPR Acquisition, except for credit cards, retail and commercial revolving lines of credits, floor plans and performing auto loans with FICO scores over 660 acquired at a premium, are accounted for by the Company in accordance with ASC 310-30.

The carrying amount corresponding to non-covered loans acquired with deteriorated credit quality, including those accounted under ASC 310-30 by analogy, in the statement of financial condition at June 30, 2013 and December 31, 2012 is as follows:

	June 30, 2013	December 31, 2012
	(In thousands)	
Contractual required payments receivable	\$ 3,429,294	\$ 3,954,484
Less: Non-accretable discount	713,641	741,872
Cash expected to be collected	2,715,653	3,212,612
Less: Accretable yield	496,061	590,409
Carrying amount	\$ 2,219,592	\$ 2,622,203

The following tables describe the accretable yield and non-accretable discount activity of acquired loans accounted for under ASC 310-30 for the quarter and six-month period ended June 30, 2013, excluding covered loans:

	Quarter Ended June 30, 2013	Six-Month Period Ended June 30, 2013
	(In thousands)	
Accretable Yield Activity		
Balance at beginning of period	\$ 542,741	\$ 590,409
Accretion	(54,427)	(102,095)
Transfer from non-accretable discount	7,747	7,747
Balance at end of period	\$ 496,061	\$ 496,061

	Quarter Ended June 30, 2013	Six-Month Period Ended June 30, 2013
	(In thousands)	

Non-Accretable Discount Activity

Balance at beginning of period	\$	733,126	\$	741,872
Principal losses		(11,738)		(20,484)
Transfer to accretable yield		(7,747)		(7,747)
Balance at end of period	\$	713,641	\$	713,641

23

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Covered Loans

The carrying amount of covered loans at June 30, 2013 and December 31, 2012 is as follows:

	June 30, 2013		December 31, 2012	
	(In thousands)			
Contractual required payments receivable	\$	782,763	\$	874,994
Less: Non-accretable discount		192,259		237,555
Cash expected to be collected		590,504		637,439
Less: Accretable yield		167,132		188,008
Carrying amount, gross		423,372		449,431
Less: Allowance for covered loan and lease losses		53,992		54,124
Carrying amount, net	\$	369,380	\$	395,307

The following tables describe the accretable yield and non-accretable discount activity of covered loans for the quarters and six-month periods ended June 30, 2013 and 2012:

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
Accretable yield activity				
Balance at beginning of period	\$	174,107	\$	174,878
Accretion		(23,999)		(20,342)
Transfer from non-accretable discount		17,024		23,352
Balance at end of period	\$	167,132	\$	177,248

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
Non-accretable discount activity				
Balance at beginning of period	\$	214,236	\$	379,780
Principal losses		(4,953)		(21,944)

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Transfer to accretable yield		(17,024)		(22,712)		(23,352)		(30,310)
Balance at end of period	\$	192,259	\$	314,404	\$	192,259	\$	314,404

24

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Non-accrual Loans

The following table presents the recorded investment in loans in non-accrual status by class of loans as of June 30, 2013 and December 31, 2012:

	June 30, 2013		December 31, 2012
	(In thousands)		
<u>Originated and other loans and leases held for investment</u>			
Mortgage			
Traditional (by origination year):			
Up to the year 2002	\$ 6,987	\$	11,362
Years 2003 and 2004	3,465		18,162
Year 2005	1,481		8,859
Year 2006	2,875		15,363
Years 2007, 2008 and 2009	3,580		8,967
Years 2010, 2011, 2012 and 2013	3,988		1,162
	22,376		63,875
Non-traditional	2,287		11,160
Loss mitigation program	28,450		39,957
	53,113		114,992
Home equity secured personal loans	12		10
	53,125		115,002
Commercial			
Commercial secured by real estate	29,491		26,517
Other commercial and industrial	2,939		2,989
	32,430		29,506
Consumer			
Auto and leasing	370		442
	1,096		131
<u>Acquired loans accounted under ASC 310-20</u>			
Commercial	493		193
Auto	674		275
Consumer	1,069		1,095
	2,236		1,563
Total non-accrual loans	\$ 89,257	\$	146,644

Loans accounted for under ASC 310-30 are excluded from the above table as they are considered to be performing due to the application of the accretion method, in which these loans will accrete interest income over the remaining life of the loans using estimated cash flow analyses.

These loans do not include certain non-performing residential mortgage loans with a net book value of \$55.0 million reclassified during the quarter ended June 30, 2013 to the loan held-for-sale category. Without this re-classification to loans held-for-sale, non-accruing loan balances would have been relatively consistent between December 31, 2012 and June 30, 2013.

Effective April 24, 2013, delinquent residential mortgage loans insured or guaranteed under applicable FHA and VA programs are placed in non-accrual when they become 18 months or more past due, since they are insured loans. Before that date, they were placed in non-accrual when they became 90 days or more past due.

At June 30, 2013 and December 31, 2012, loans whose terms have been extended and which are classified as troubled-debt restructurings that are not included in non-accrual loans amounted to \$55.7 million and \$52.0 million, respectively.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 5 - ALLOWANCE FOR LOAN AND LEASE LOSSES

Non-Covered Loans

The Company maintains an allowance for loan and lease losses at a level that management considers adequate to provide for probable losses based upon an evaluation of known and inherent risks. The Company's allowance for loan and lease losses policy provides for a detailed quarterly analysis of probable losses. The analysis includes a review of historical loan loss experience, value of underlying collateral, current economic conditions, financial condition of borrowers and other pertinent factors. While management uses available information in estimating probable loan losses, future additions to the allowance may be required based on factors beyond the Company's control. We also maintain an allowance for loan losses on acquired loans when: (i) for loans accounted for under ASC 310-30, there is deterioration in credit quality subsequent to acquisition, and (ii) for loans accounted for under ASC 310-20, the inherent losses in the loans exceed the remaining credit discount recorded at the time of acquisition.

Originated and Other Loans and Leases Held for Investment

The following tables present the activity in our allowance for loan and lease losses and the related recorded investment of the associated loans for our originated and other loans held for investment portfolio by segment for the periods indicated:

	Quarter Ended June 30, 2013						
	Mortgage	Commercial	Consumer	Auto and Leasing	Unallocated	Total	
	(In thousands)						
Allowance for loan and lease losses:							
Balance at beginning of period	\$ 22,889	\$ 16,314	\$ 1,313	\$ 1,741	\$ 77	\$ 42,334	
Charge-offs	(29,120)	(2,886)	(323)	(709)	-	(33,038)	
Recoveries	-	234	43	209	-	486	
Provision for non-covered loan and lease losses	27,606	3,961	1,309	2,400	643	35,919	
	\$ 21,375	\$ 17,623	\$ 2,342	\$ 3,641	\$ 720	\$ 45,701	

**Balance at end
of period**

Six-Month Period Ended June 30, 2013

	Mortgage	Commercial	Consumer	Auto and Leasing	Unallocated	Total
	(In thousands)					
Allowance for loan and lease losses:						
Balance at beginning of period	\$ 21,092	\$ 17,072	\$ 856	\$ 533	\$ 368	\$ 39,921
Charge-offs	(31,707)	(3,444)	(569)	(800)	-	(36,520)
Recoveries	-	262	107	216	-	585
Provision for non-covered loan and lease losses	31,990	3,733	1,948	3,692	352	41,715
Balance at end of period	\$ 21,375	\$ 17,623	\$ 2,342	\$ 3,641	\$ 720	\$ 45,701

26

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

	June 30, 2013						
	Mortgage	Commercial	Consumer	Auto and Leasing	Unallocated	Total	
	(In thousands)						
Allowance for loan and lease losses:							
Ending allowance balance attributable							
to loans:							
Individually evaluated for impairment	\$ 8,879	\$ 5,795	\$ -	\$ -	\$ -	\$ -	\$ 14,674
Collectively evaluated for impairment	12,496	11,828	2,342	3,641	720		31,027
Total ending allowance balance	\$ 21,375	\$ 17,623	\$ 2,342	\$ 3,641	\$ 720	\$ -	\$ 45,701
Loans:							
Individually evaluated for impairment	\$ 81,849	\$ 43,831	\$ -	\$ -	\$ -	\$ -	\$ 125,680
Collectively evaluated for impairment	673,449	658,244	89,608	233,091	-		1,654,392
Total ending loan balance	\$ 755,298	\$ 702,075	\$ 89,608	\$ 233,091	\$ -	\$ -	\$ 1,780,072

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

	Quarter Ended June 30, 2012						Total
	Mortgage	Commercial	Consumer	Leasing	Unallocated		
	(In thousands)						
Allowance for loan and lease losses:							
Balance at beginning of period	\$ 18,967	\$ 15,045	\$ 1,328	\$ 510	\$ 1,511	\$ 37,361	
Charge-offs	(1,948)	(1,721)	(184)	-	-	(3,853)	
Recoveries	-	34	56	4	-	94	
Provision for (recapture of) non-covered loan and lease losses	2,769	2,620	(202)	(317)	(1,070)	3,800	
Balance at end of period	\$ 19,788	\$ 15,978	\$ 998	\$ 197	\$ 441	\$ 37,402	

	Six-Month Period Ended June 30, 2012						Total
	Mortgage	Commercial	Consumer	Leasing	Unallocated		
	(In thousands)						
Allowance for loan and lease losses:							
Balance at beginning of period	\$ 21,652	\$ 12,548	\$ 1,423	\$ 845	\$ 542	\$ 37,010	
Charge-offs	(2,869)	(3,358)	(366)	(31)	-	(6,624)	
Recoveries	-	101	107	8	-	216	
Provision for (recapture of) non-covered loan and lease losses	1,005	6,687	(166)	(625)	(101)	6,800	
Balance at end of period	\$ 19,788	\$ 15,978	\$ 998	\$ 197	\$ 441	\$ 37,402	

	December 31, 2012					Total
	Mortgage	Commercial	Consumer	Auto and Leasing	Unallocated	
	(In thousands)					
Allowance for loan and lease losses:						

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Ending allowance
balance attributable to
loans:

Individually evaluated for impairment	\$	5,334	\$	4,121	\$	-	\$	-	\$	-	\$	9,455
Collectively evaluated for impairment		15,758		12,951		856		533		368		30,466
Total ending allowance balance	\$	21,092	\$	17,072	\$	856	\$	533	\$	368	\$	39,921

Loans:

Individually evaluated for impairment	\$	74,783	\$	46,199	\$	-	\$	-	\$	-	\$	120,982
Collectively evaluated for impairment		730,159		307,731		48,136		50,720		-		1,136,746
Total ending loans balance	\$	804,942	\$	353,930	\$	48,136	\$	50,720	\$	-	\$	1,257,728

28

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Acquired Loans Accounted for under ASC 310-20 (Loans with revolving feature and/or acquired at a premium)

The following tables present the activity in our allowance for loan losses and related recorded investment of the associated loans in our non-covered acquired loan portfolio, excluding loans accounted for under ASC 310-30, for the quarter and six-month period ended June 30, 2013:

	Quarter Ended June 30, 2013				
	Commercial	Consumer	Auto	Unallocated	Total
Allowance for loan and lease losses:					
Balance at beginning of period	\$ 386	\$ -	\$ -	\$ -	\$ 386
Charge-offs	(25)	(1,158)	(1,410)	-	(2,593)
Recoveries	-	637	886	-	1,523
Provision for non-covered					
loan and lease losses	563	521	524	-	1,608
Balance at end of period	\$ 924	\$ -	\$ -	\$ -	\$ 924

	Six-Month Period Ended June 30, 2013				
	Commercial	Consumer	Auto	Unallocated	Total
Allowance for loan and lease losses:					
Charge-offs	(25)	(2,614)	(3,125)	-	(5,764)
Recoveries	-	844	2,116	-	2,960
Provision for non-covered					
loan and lease losses	949	1,770	1,009	-	3,728
Balance at end of period	\$ 924	\$ -	\$ -	\$ -	\$ 924

	June 30, 2013				Total
	Commercial	Consumer	Auto	Unallocated	

Allowance for loan and lease losses:

Ending allowance balance attributable

to loans:

Collectively evaluated for impairment	924	-	-	-	924
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Total ending allowance balance	\$ 924	\$ -	\$ -	\$ -	\$ 924
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Loans:

Collectively evaluated for impairment	154,753	62,751	373,587	-	591,091
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Total ending loan balance	\$ 154,753	\$ 62,751	\$ 373,587	\$ -	\$ 591,091
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OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Impaired Loans

The Company evaluates all loans, some individually and others as homogeneous groups, for purposes of determining impairment. The total investment in impaired commercial loans was \$43.8 million and \$46.2 million at June 30, 2013 and December 31, 2012, respectively. The impaired commercial loans were measured based on the fair value of collateral or the present value of cash flows method, including those identified as troubled-debt restructurings. The valuation allowance for impaired commercial loans amounted to approximately \$5.8 million and \$4.1 million at June 30, 2013 and December 31, 2012, respectively. The total investment in impaired mortgage loans was \$81.8 million and \$74.8 million at June 30, 2013 and December 31, 2012, respectively. Impairment on mortgage loans assessed as troubled-debt restructurings was measured using the present value of cash flows. The valuation allowance for impaired mortgage loans amounted to approximately \$8.9 million and \$5.3 million at June 30, 2013 and December 31, 2012, respectively.

The Company's recorded investment in commercial and mortgage loans that were individually evaluated for impairment, excluding loans accounted for under ASC 310-30, and the related allowance for loan and lease losses at June 30, 2013 and December 31, 2012 are as follows:

Originated and Other Loans and Leases Held for Investment

		Unpaid Principal		June 30, 2013 Recorded Investment (In thousands)		Related Allowance		Coverage
Impaired loans with specific allowance:								
Commercial	\$	22,168	\$	19,276	\$	5,795		30%
Residential troubled-debt restructuring		85,271		81,849		8,879		11%
Impaired loans with no specific allowance:								
Commercial		31,334		24,555		N/A		N/A
Total investment in impaired loans	\$	138,773	\$	125,680	\$	14,674		12%

	Unpaid Principal	December 31, 2012 Recorded Investment (In thousands)		Related Allowance	Coverage
Impaired loans with specific allowance					
Commercial	\$	16,666	\$ 14,570	\$ 4,121	28%
Residential		76,859	74,783	5,334	7%
troubled-debt restructuring					
Impaired loans with no specific allowance					
Commercial		36,293	31,629	N/A	N/A
Total investment in impaired loans	\$	129,818	\$ 120,982	\$ 9,455	8%

Acquired Loans Accounted for under ASC-310-20 (Loans with revolving feature and/or acquired at a premium)

	Unpaid Principal	June 30, 2013 Recorded Investment (In thousands)		Specific Allowance	Coverage
Impaired loans with no specific allowance					
Commercial		36,293	31,629	N/A	N/A
Total investment in impaired loans	\$	36,293	\$ 31,629	-	0%

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table presents the interest recognized in commercial and mortgage loans that were individually evaluated for impairment, excluding loans accounted for under ASC 310-30, for the quarters and six-month periods ended June 30, 2013 and 2012:

	Quarter Ended June 30,			
	2013			2012
	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment
	(In thousands)			
Impaired loans with specific allowance				
Commercial	\$ 255	\$ 17,049	\$ 132	\$ 16,105
Residential troubled-debt restructuring	682	83,081	461	62,548
Impaired loans with no specific allowance				
Commercial	226	23,304	49	25,031
Total interest income from impaired loans	\$ 1,163	\$ 123,434	\$ 642	\$ 103,684

	Six-Month Period Ended June 30,			
	2013			2012
	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment
Impaired loans with specific allowance				
Commercial	\$ 322	\$ 17,789	\$ 264	\$ 20,516
Residential troubled-debt restructuring	1,273	80,914	874	59,466
Impaired loans with no specific allowance				
Commercial	364	25,304	104	21,864
Total interest income from impaired loans	\$ 1,959	\$ 124,007	\$ 1,242	\$ 101,846

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Modifications

The following table presents the troubled-debt restructurings during the quarters and six-month periods ended June 30, 2013 and 2012:

	Quarter Ended June 30, 2013						
	Pre-Modification Number of Outstanding contracts	Pre-Modification Recorded Investment	Pre-Modification Weighted Average Rate	Pre-Modification Weighted Average Term (in Months) (Dollars in thousands)	Post-Modification Recorded Investment	Post-Modification Weighted Average Rate	Post-Modification Weighted Average Term (in Months)
Mortgage loans	42	\$ 5,372	6.47%	355	\$ 5,715	4.26%	420
Commercial loans	2	1,842	8.99%	87	1,842	4.00%	66
Consumer loans	2	18	13.67%	41	18	13.67%	60

	Six-Month Period Ended June 30, 2013						
	Pre-Modification Number of Outstanding contracts	Pre-Modification Recorded Investment	Pre-Modification Weighted Average Rate	Pre-Modification Weighted Average Term (in Months) (Dollars in thousands)	Post-Modification Recorded Investment	Post-Modification Weighted Average Rate	Post-Modification Weighted Average Term (in Months)
Mortgage loans	86	\$ 10,555	6.56%	342	\$ 11,288	4.59%	417
Commercial loans	2	1,842	8.99%	87	1,842	4.00%	66
Consumer loans	2	18	13.67%	41	18	13.67%	60

	Quarter Ended June 30, 2012						
	Pre-Modification Number of Outstanding contracts	Pre-Modification Recorded Investment	Pre-Modification Weighted Average Rate	Pre-Modification Weighted Average Term (in Months)	Post-Modification Recorded Investment	Post-Modification Weighted Average Rate	Post-Modification Weighted Average Term (in Months)

(Dollars in thousands)

Mortgage loans	45	\$ 6,028	6.52%	290	\$ 6,380	4.95%	378
Commercial loans	3	3,698	6.25%	65	3,968	6.08%	71

Six-Month Period Ended June 30, 2012

	Pre-Modification	Pre-Modification	Pre-Modification	Post-Modification	Post-Modification	Post-Modification	Post-Modification
	Outstanding	Pre-Modification	Weighted	Outstanding	Post-Modification	Weighted	Weighted
	Number of	Recorded	Weighted	Average Term	Recorded	Weighted	Average Term (in
	contracts	Investment	Average Rate	(in Months)	Investment	Average Rate	Months)
Mortgage loans	103	\$ 15,473	6.50%	313	\$ 16,419	4.96%	393
Commercial loans	6	5,600	5.80%	49	5,407	6.22%	65

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table presents troubled-debt restructurings for which there was a payment default during the twelve-month periods ended June 30, 2013 and 2012:

	Twelve-Month Period Ended June 30, 2013		Twelve-Month Period Ended June 30, 2012	
	Number of Contracts	Recorded Investment (Dollars in thousands)	Number of Contracts	Recorded Investment
Mortgage loans	48	\$ 6,414	32	\$ 4,110
Consumer	2	\$ 29	-	\$ -

Credit Quality Indicators

The Company categorizes non-covered originated and acquired loans accounted for under ASC 310-20 into risk categories based on relevant information about the ability of borrowers to service their debt, such as economic conditions, portfolio risk characteristics, prior loss experience, and the results of periodic credit reviews of individual loans.

The Company uses the following definitions for risk ratings:

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

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

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

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

As of June 30, 2013 and December 31, 2012, and based on the most recent analysis performed, the risk category of gross non-covered originated and acquired loans accounted for under ASC 310-20 subject to risk rating by class of loans is as follows:

	Balance Outstanding	June 30, 2013 Risk Ratings				Individually Measured for Impairment
		Pass (In thousands)	Special Mention	Substandard	Doubtful	
Commercial - originated and other loans held for investment						
Commercial secured						
by						
real						
estate \$	412,958	\$ 346,115	\$ 29,355	\$ 1,293	\$ 282	\$ 35,913
Other						
commercial						
and						
industrial	289,117	278,319	2,763	118	-	7,918
	702,075	624,434	32,118	1,411	282	43,831
Commercial - acquired loans						
(under ASC 310-20)						
Commercial secured						
by						
real						
estate	14,519	14,031	245	244	-	-
Other						
commercial						
and						
industrial	140,234	137,786	727	1,721	-	-
	154,753	151,817	972	1,965	-	-

Total	\$	856,828	\$	776,251	\$	33,090	\$	3,376	\$	282	\$	43,831
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	Balance Outstanding	December 31, 2012 Risk Ratings				Individually Measured for Impairment
		Pass	Special Mention	Substandard	Doubtful	
Commercial - originated and other loans held for investment						
Commercial secured						
by real estate	\$ 251,274	\$ 183,033	\$ 23,928	\$ 2,127	\$ 99	\$ 42,087
Other commercial						
and industrial	102,656	85,806	8,569	4,169	-	4,112
	353,930	268,839	32,497	6,296	99	46,199
Commercial - acquired loans						
<u>(under ASC 310-20)</u>						
Construction and commercial						
real estate	20,337	19,701	245	391	-	-
Commercial and industrial	317,632	315,085	213	2,334	-	-
	337,969	334,786	458	2,725	-	-
Total	\$ 691,899	\$ 603,625	\$ 32,955	\$ 9,021	\$ 99	\$ 46,199

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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For residential and consumer loan classes, the Company evaluates credit quality based on the delinquency status of the loan. As of June 30, 2013 and December 31, 2012, and based on the most recent analysis performed, the risk category of non-covered gross originated loans and acquired loans accounted for under ASC 310-20 not subject to risk rating by class of loans is as follows:

Balance	June 30, 2013 Delinquency						Impairment	
	Individually Measured for							
	Outstanding	0-29 days	30-59 days	60-89 days	90-119 days	120-364 days	365+ days	
	(In thousands)							
Originated and other loans and leases held for investment								
Mortgage								
Traditional								
(by origination year)								
Up to the								
year 2002	\$ 89,596	\$ 84,184	\$ -	\$ 2,937	\$ 367	\$ 87	\$ 1,719	\$ 302
Years 2003								
and 2004	126,596	117,665	-	5,413	1,319	737	1,373	89
Year 2005	68,763	65,026	-	2,136	663	267	502	169
Year 2006	93,821	87,259	-	3,369	968	440	1,273	512
Years 2007, 2008								
and 2009	110,439	104,041	-	2,782	342	2,199	676	399
Years 2010, 2011,								
2012 and								
2013	98,776	94,271	-	391	951	800	365	1,998
	587,991	552,446	-	17,028	4,610	4,530	5,908	3,469
Non-traditional	46,427	42,695	-	1,520	807	160	1,152	93
Loss mitigation program	87,615	7,980	-	98	47	234	969	78,287
	722,033	603,121	-	18,646	5,464	4,924	8,029	81,849
Home equity secured	752	740	-	-	-	-	12	-

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personal									
loans									
GNMA's									
buy-back option									
program	32,513	-	-	-	5,782	15,775	10,956	-	-
	755,298	603,861	-	18,646	11,246	20,699	18,997	81,849	-
Consumer	89,608	88,218	660	156	167	199	-	208	-
Auto and	233,092	221,095	8,826	2,075	759	337	-	-	-
Leasing	1,077,998	913,174	9,486	20,877	12,172	21,235	18,997	82,057	-
Acquired loans									
(under ASC									
310-20)									
Auto	373,588	362,173	8,849	1,892	495	179	-	-	-
Consumer	62,751	59,908	1,767	7	1,054	15	-	-	-
	436,339	422,081	10,616	1,899	1,549	194	-	-	-
Total	\$ 1,514,337	\$ 1,335,255	\$ 20,102	\$ 22,776	\$ 13,721	\$ 21,429	\$ 18,997	\$ 82,057	\$ -

35

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Balance	December 31, 2012 Delinquency						Impairment									
	Individually Measured for		Outstanding													
			0-29 days	30-59 days	60-89 days	90-119 days	120-364 days	365+ days								
	(In thousands)															
Originated and other loans and leases held for investment																
Mortgage																
Traditional																
(by origination year):																
Up to the	\$	101,268	\$	80,715	\$	6,907	\$	2,116	\$	886	\$	3,720	\$	6,442	\$	482
Year 2002																
and 2003		149,862		114,341		12,048		5,206		2,082		3,994		11,533		658
Year 2004																
Year 2005		80,900		65,245		4,983		1,746		1,202		1,846		5,727		151
Year 2006		113,086		84,926		9,012		3,525		1,530		5,103		8,695		295
Years 2007, 2008																
and 2009		121,639		108,357		2,632		1,682		641		2,532		5,732		63
Years 2010, 2011																
and 2012		66,646		64,084		632		769		249		452		460		-
		633,401		517,668		36,214		15,044		6,590		17,647		38,589		1,649
Non-traditional		57,819		42,742		2,850		1,067		455		2,287		8,418		-
Loss mitigation program		87,310		9,595		606		128		102		253		3,492		73,134
Home equity secured		778,530		570,005		39,670		16,239		7,147		20,187		50,499		74,783
		736		726		-		-		-		-		10		-

personal loans GNMA's buy back									
option program	25,676	-	-	-	6,064	10,659	8,953	-	
	804,942	570,731	39,670	16,239	13,211	30,846	59,462	74,783	
Consumer	48,136	46,888	747	92	188	218	3	-	
Auto and leasing	50,720	50,209	251	129	46	85	-	-	
	903,798	667,828	40,668	16,460	13,445	31,149	59,465	74,783	
Acquired loans (under ASC 310-20)									
Mortgage	1,591	1,070				521			
Auto	457,894	449,843	6,753	1,023	264	11	-	-	
Consumer	68,878	66,801	982	-	1,089	4	2	-	
	528,363	517,714	7,735	1,023	1,353	536	2	-	
Total	\$ 1,432,161	\$ 1,185,542	\$ 48,403	\$ 17,483	\$ 14,798	\$ 31,685	\$ 59,467	\$ 74,783	

The reduction in mortgage loans over 90 days past due from December 31, 2012 is due to the reclassification of certain non-performing residential mortgage loans originated before 2010, with the a net book value of \$55.0 million to the loan held-for-sale category.

Non-covered Acquired Loans Accounted under ASC 310-30

Loans acquired in the BBVAPR Acquisition accounted for under ASC 310-30 were recognized at fair value as of December 18, 2012, which included the impact of expected credit losses, and therefore, no allowance for credit losses was recorded at the acquisition date. To the extent credit deterioration occurs after the date of acquisition, the Company would record an allowance for loan and lease losses. Management determined that there was no need to record an allowance for loan and lease losses on loans acquired in the BBVAPR Acquisition accounted for under ASC 310-30 as of June 30, 2013 and December 31, 2012.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Covered Loans

For covered loans, as part of the evaluation of actual versus expected cash flows, the Company assesses on a quarterly basis the credit quality of these loans based on delinquency, severity factors and risk ratings, among other assumptions. Migration and credit quality trends are assessed at the pool level, by comparing information from the latest evaluation period through the end of the reporting period.

The changes in the allowance for loan and lease losses on covered loans for the quarters and six-month periods ended June 30, 2013 and 2012 were as follows:

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
Balance at beginning of the period	\$ 52,974	\$ 56,437	\$ 54,124	\$ 37,256
Provision for covered loan and lease losses, net	1,210	1,467	1,882	8,624
FDIC shared-loss portion of provision for (recapture of) covered loan and lease losses, net	(192)	724	(2,014)	12,748
Balance at end of the period	\$ 53,992	\$ 58,628	\$ 53,992	\$ 58,628

FDIC shared-loss portion of provision for (recapture of) covered loans and lease losses net, represents the credit impairment losses to be covered under the FDIC loss-share agreement which is increasing (decreasing) the FDIC loss-share indemnification asset.

Provision for covered loans and lease losses for the quarter and six-month period ended June 30, 2013 was \$1.2 million and \$1.9 million, respectively, reflecting the Company's quarterly revision of the expected cash flows in the covered loan portfolio considering actual experiences and changes in the Company's expectations for the remaining terms of the loan pools. During the quarter ended June 30, 2013, a commercial real estate loan pool underperformed, requiring additional allowance for the quarter. The six-month period ended June 30, 2013, is mainly affected by the aforementioned commercial real estate pool together with two pools of non-performing residential mortgage loans pools. The six-month period ended June 30, 2013 was benefited by the reversal of the allowance of pools of commercial and industrial loans and pools of commercial loans secured by real estate.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Company's recorded investment in covered loan pools that have recorded impairments and their related allowance for covered loan and lease losses as of June 30, 2013 and December 31, 2012 are as follows:

		June 30, 2013			
	Unpaid Principal	Recorded Investment (In thousands)	Specific Allowance	Coverage	
Impaired covered loan pools with specific allowance					
Loans secured by 1-4 family residential properties	\$ 51,613	\$ 36,483	\$ 7,072		19%
Construction and development secured by 1-4 family residential properties	66,024	16,170	6,741		42%
Commercial and other construction	242,054	75,941	39,504		52%
Consumer	12,790	6,818	675		10%
Total investment in impaired covered loan pools	\$ 372,481	\$ 135,412	\$ 53,992		40%

		December 31, 2012			
	Unpaid Principal	Recorded Investment (In thousands)	Specific Allowance	Coverage	
Impaired covered loan pools with specific allowance					
Loans secured by 1-4 family residential properties	\$ 45,208	\$ 29,482	\$ 4,986		17%
Construction and development secured by 1-4 family residential properties	68,255	15,185	6,137		40%
Commercial and other construction	252,373	121,237	42,323		35%
Consumer	14,494	8,493	678		8%
Total investment in impaired covered loan pools	\$ 380,330	\$ 174,397	\$ 54,124		31%

NOTE 6 — PREMISES AND EQUIPMENT

Premises and equipment at June 30, 2013 and December 31, 2012 are stated at cost less accumulated depreciation and amortization as follows:

	Useful Life (Years)		June 30, 2013 (In thousands)	December 31, 2012
Land	—	\$	5,677	\$ 2,876
Buildings and improvements	40		63,673	63,133
Leasehold improvements	5 — 10		23,637	23,602
Furniture and fixtures	3 — 7		11,685	10,441
Information technology and other	3 — 7		23,271	20,874
			127,943	120,926
Less: accumulated depreciation and amortization			(43,642)	(35,929)
		\$	84,301	\$ 84,997

Depreciation and amortization of premises and equipment totaled \$3.0 million and \$6.1 million in the quarter and six-month period ended June 30, 2013, respectively, and \$1.2 million and \$2.4 million in the quarter and six-month period ended June 30, 2012, respectively. These are included in the unaudited consolidated statements of operations as part of occupancy and equipment expenses.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 7 — DERIVATIVE ACTIVITIES

During the quarter and six-month period ended June 30, 2013, gains of \$1.6 million and \$1.3 million, respectively, were recognized and reflected as “Derivative Activities” in the unaudited consolidated statements of operations, which were mainly related to the mortgage hedging activities. During the quarter and six-month period ended June 30, 2012, there were no significant transactions impacting the Company’s operations reflected as “Derivative Activities” in the unaudited consolidated statements of operations.

The following table details “Derivative Assets” and “Derivative Liabilities” as reflected in the unaudited consolidated statements of financial condition at June 30, 2013 and December 31, 2012:

	June 30, 2013		December 31, 2012
	(In thousands)		
Derivative assets:			
Options tied to S&P 500 Index	\$ 16,020	\$	13,233
Interest rate swaps not designated as hedges	3,245		8,426
Interest rate caps	270		230
Other	120		-
	\$ 19,655	\$	21,889
Derivative liabilities:			
Interest rate swaps designated as cash flow hedges	\$ 13,187	\$	17,665
Interest rate swaps not designated as hedges	3,244		8,365
Interest rate caps	270		230
	\$ 16,701	\$	26,260

Interest Rate Swaps

The Company enters into interest rate swap contracts to hedge the variability of future interest cash flows of forecasted wholesale borrowings, attributable to changes in a predetermined variable index rate. The interest rate swaps effectively fix the Company’s interest payments on an amount of forecasted interest expense attributable to the variable index rate corresponding to the swap notional stated rate. These swaps are designated as cash flow hedges for the forecasted wholesale borrowings transactions and are properly documented as such, and therefore, qualify for cash flow hedge accounting. Any gain or loss associated with the effective portion of our cash flow hedges was recognized

in other comprehensive income and is subsequently reclassified into earnings in the period during which the hedged forecasted transactions affect earnings. Changes in the fair value of these derivatives are recorded in accumulated other comprehensive income to the extent there is no significant ineffectiveness in the cash flow hedging relationships. Currently, the Company does not expect to reclassify any amount included in other comprehensive income related to these interest rate swaps to earnings in the next twelve months.

The following table shows a summary of these swaps and their terms at June 30, 2013:

Type	Notional Amount (In thousands)	Fixed Rate	Variable Rate Index	Trade Date	Settlement Date	Maturity Date
Interest Rate Swaps	\$ 25,000	2.4365%	1-Month Libor	05/05/11	05/04/12	05/04/16
	25,000	2.6200%	1-Month Libor	05/05/11	07/24/12	07/24/16
	25,000	2.6350%	1-Month Libor	05/05/11	07/30/12	07/30/16
	50,000	2.6590%	1-Month Libor	05/05/11	08/10/12	08/10/16
	100,000	2.6750%	1-Month Libor	05/05/11	08/16/12	08/16/16
	\$ 225,000					

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

An unrealized loss of \$13.2 million was recognized in accumulated other comprehensive income related to the valuation of these swaps at June 30, 2013, and the related liability is being reflected in the accompanying unaudited consolidated statements of financial condition.

At June 30, 2013 and December 31, 2012, interest rate swaps not designated as hedging instruments that were offered to clients represented an asset of \$3.2 million and \$8.4 million, respectively, and were included as part of derivative assets in the unaudited consolidated statements of financial position. The credit risk to these clients stemming from these derivatives, if any, is not material. At June 30, 2013 and December 31, 2012, interest rate swaps not designated as hedging instruments that are the mirror-images of the derivatives offered to clients represented a liability of \$3.2 million and \$8.4 million, respectively, and were included as part of derivative liabilities in the unaudited consolidated statements of financial condition.

The following table shows a summary of these interest rate swaps not designated as hedging instruments and their terms at June 30, 2013:

Type	Notional Amount (In thousands)	Fixed Rate	Variable Rate Index	Settlement Date	Maturity Date
Interest Rate Swaps - Derivatives Offered to Clients	\$				
	4,232	5.1300%	1-Month Libor	07/03/06	07/03/16
	12,500	5.5050%	1-Month Libor	04/11/09	04/11/19
	1,150	5.1500%	3-Month Libor	10/24/08	10/24/13
	\$ 17,882				
Interest Rate Swaps - Mirror Image Derivatives	\$				
	4,232	5.1300%	1-Month Libor	07/03/06	07/03/16
	12,500	5.5050%	1-Month Libor	04/11/09	04/11/19
	1,150	4.9550%	3-Month Libor	10/24/08	10/24/13
	\$ 17,882				

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

The Company has offered its customers certificates of deposit with an option tied to the performance of the S&P 500 Index. The Company uses option agreements with major broker-dealers to manage its exposure to changes in this index. Under the terms of the option agreements, the Company receives the average increase in the month-end value of the index in exchange for a fixed premium. The changes in fair value of the option agreements used to manage the exposure in the stock market in the certificates of deposit are recorded in earnings. At June 30, 2013 and December 31, 2012, the purchased options used to manage exposure to the S&P 500 Index on stock indexed deposits represented an asset of \$16.0 million (notional amount of \$49.1 million) and \$13.2 million (notional amount of \$66.6 million), respectively, and the options sold to customers embedded in the certificates of deposit and recorded as deposits in the unaudited consolidated statements of financial condition, represented a liability of \$15.3 million (notional amount of \$42.9 million) and \$12.7 million (notional amount of \$62.3 million), respectively.

Interest rate caps

The Company has entered into interest rate cap transactions with various clients with floating-rate debt who wish to protect their financial results against increases in interest rates. In these cases, the Company simultaneously enters into mirror-image interest rate cap transactions with financial counterparties. None of these cap transactions qualify for hedge accounting; therefore, they are marked to market through earnings. The outstanding total notional amount of interest rate caps was \$94.0 million June 30, 2013 and December 31, 2012. At June 30, 2013, the interest rate caps sold to clients represented a liability of \$270 thousand and were included as part of derivative liabilities in the unaudited consolidated statements of financial condition. At June 30, 2013, the interest rate caps purchased as mirror-images represented an asset of \$270 thousand and were included as part of derivative assets in the unaudited consolidated statements of financial condition.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 8 — ACCRUED INTEREST RECEIVABLE AND OTHER ASSETS

Accrued interest receivable at June 30, 2013 and December 31, 2012 consists of the following:

		June 30, 2013		December 31, 2012
		(In thousands)		
Non-covered loans	\$	11,459	\$	10,533
Investments		6,049		7,021
	\$	17,508	\$	17,554

Other assets at June 30, 2013 and December 31, 2012 consist of the following:

		June 30, 2013		December 31, 2012
		(In thousands)		
Prepaid FDIC insurance	\$	-	\$	6,451
Other prepaid expenses		23,568		19,674
Servicing advances		-		7,976
Mortgage tax credits		8,706		8,706
Core deposit and customer relationship intangibles		13,201		14,490
Investment in Statutory Trust		1,086		1,086
Other repossessed assets		8,921		6,084
Accounts receivable and other assets		48,980		59,175
	\$	104,462	\$	123,642

On November 12, 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay on December 31, 2009 their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, along with each institution's risk-based deposit insurance assessment for the third quarter of 2009. The prepayment balance of the assessment amounted to \$6.5 million at December 31, 2012. Pursuant to guidelines issued by the FDIC, the assessment due for the first quarter of 2013 paid on June 28, 2013 was offset by the amount of the credit for prepaid assessments.

Other prepaid expenses amounting to \$23.6 million and \$19.7 million at June 30, 2013 and December 31, 2012, respectively, include prepaid municipal, property and income taxes aggregating to \$17.1 million and \$12.0 million, respectively.

Servicing advances amounting to \$8.0 million at December 31, 2012, represent the advances made to Bayview Loan Servicing, LLC in order to service some of the loans acquired in the FDIC-assisted acquisition of Eurobank. This servicing agreement was terminated effective May 31, 2013.

At June 30, 2013 and December 31, 2012, tax credits for the Company amounted \$8.7 million. Mortgage loan tax credits acquired as part of the BBVAPR Acquisition amounted to \$6.3 million and \$7.4 million at June 30, 2013 and December 31, 2012, respectively. These tax credits do not have an expiration date.

As part of the FDIC-assisted acquisition of Eurobank and the recent BBVAPR Acquisition, the Company recorded a core deposit intangible representing the value of checking and savings deposits acquired. At June 30, 2013 and December 31, 2012, this core deposit intangible amounted to \$8.6 million and \$9.5 million, respectively. In addition, as part of the BBVAPR Acquisition on December 18, 2012, the Company recorded a customer relationship intangible amounting to \$5.0 million representing the value of customer relationships acquired in the broker-dealer and insurance subsidiaries as of December 31, 2012. At June 30, 2013, this customer relationship intangible amounted to \$4.6 million.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Other repossessed assets totaled \$8.9 million and \$6.1 million at June 30, 2013 and December 31, 2012, respectively. Repossessed auto loans acquired as part of the BBVAPR Acquisition amounted to \$8.6 million and \$5.9 million at June 30, 2013 and December 31, 2012, respectively.

NOTE 9 — DEPOSITS AND RELATED INTEREST

Total deposits as of June 30, 2013 and December 31, 2012 consist of the following:

	June 30, 2013	December 31, 2012
	(In thousands)	
Non-interest bearing demand deposits	\$ 872,806	\$ 799,667
Interest-bearing savings and demand deposits	2,331,589	2,282,305
Individual retirement accounts	352,637	376,611
Retail certificates of deposit	688,877	699,983
Institutional certificates of deposits	645,037	602,828
Total core deposits	4,890,946	4,761,394
Brokered deposits	774,092	928,165
Total deposits	\$ 5,665,038	\$ 5,689,559

The weighted average interest rate of the Company's deposits was 0.73% at June 30, 2013 and 1.33% at December 31, 2012, inclusive of non-interest bearing deposits of \$934.7 million and \$799.7 million, respectively. Interest expense for the quarters and the six-month periods ended June 30, 2013 and 2012 was as follows:

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
Demand and savings deposits	\$ 5,435	\$ 2,848	\$ 11,397	\$ 6,024
Certificates of deposit	4,538	5,037	9,054	10,984
	\$ 9,973	\$ 7,885	\$ 20,451	\$ 17,008

At June 30, 2013 and December 31, 2012, demand and interest-bearing deposits and certificates of deposit included deposits of the Puerto Rico Cash & Money Market Fund Inc., which amounted to \$93.3 million and \$101.5 million, respectively, with a weighted average rate of 0.77% and 0.77%, and were collateralized with investment securities

with a fair value of \$68.3 million and \$80.3 million, respectively.

At June 30, 2013 and December 31, 2012, time deposits in denominations of \$100 thousand or higher, excluding accrued interest and unamortized discounts, amounted to \$1.18 billion and \$1.87 billion, including public fund time deposits from various Puerto Rico government municipalities, agencies, and corporations of \$170.5 million and \$78.3 million, respectively, at a weighted average rate of 0.48% at June 30, 2013 and 0.72% at December 31, 2012.

At June 30, 2013 and December 31, 2012, public fund deposits from various Puerto Rico government agencies were collateralized with investment securities with a fair value of \$98.7 million and \$114.6 million, respectively, and with commercial loans amounting to \$464.1 million at June 30, 2013 and \$485.8 million at December 31, 2012.

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

Excluding equity indexed options in the amount of \$15.3 million, which are used by the Company to manage its exposure to the S&P 500 Index, and also excluding accrued interest of \$3.3 million and unamortized deposit discounts in the amount of \$9.0 million, the scheduled maturities of certificates of deposit at June 30, 2013 are as follows:

	June 30, 2013 (In thousands)
Within one year:	
Three (3) months or less	\$ 492,297
Over 3 months through 1 year	759,405
	1,251,702
Over 1 through 2 years	634,600
Over 2 through 3 years	258,143
Over 3 through 4 years	143,128
Over 4 through 5 years	61,763
	\$ 2,349,336

The aggregate amount of overdraft in demand deposit accounts that were reclassified to loans amounted to \$1.0 million and \$2.8 million as of June 30, 2013 and December 31, 2012, respectively.

NOTE 10 — BORROWINGS***Short term borrowings***

At June 30, 2013, no short term borrowings were outstanding, compared to December 31, 2012 when these totaled \$92.2 million and mainly consisted of unsecured fixed rate borrowings with a weighted average rate of 0.30%.

Securities Sold under Agreements to Repurchase

At June 30, 2013, 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

Company the same or similar securities at the maturity of the agreements.

At June 30, 2013 and December 31, 2012, securities sold under agreements to repurchase (classified by counterparty), excluding accrued interest in the amount of \$2.3 million at both dates, were as follows:

	June 30, 2013		December 31, 2012	
	Borrowing Balance	Fair Value of Underlying Collateral (In thousands)	Borrowing Balance	Fair Value of Underlying Collateral
UBS Financial Services Inc.	\$ 500,000	\$ 597,126	\$ 500,000	\$ 616,751
JP Morgan Chase Bank NA	255,000	273,783	412,837	443,436
Credit Suisse Securities (USA) LLC	255,000	270,180	255,000	269,943
Deutsche Bank	255,000	271,702	255,000	273,288
Citigroup Global Markets Inc.	46,573	52,473	150,000	162,652
Barclays Bank	-	-	68,650	77,521
Wells Fargo	-	-	51,444	54,943
Total	\$ 1,311,573	\$ 1,465,264	\$ 1,692,931	\$ 1,898,534

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table shows a summary of the Company's repurchase agreements and their terms, excluding accrued interest in the amount of \$2.3 million, at June 30, 2013:

Year of Maturity	Borrowing Balance (In thousands)	Weighted- Average Coupon	Settlement Date	Maturity Date
2013	\$ 46,573	0.420%	6/25/2013	7/8/2013
2014	255,000	0.500%	12/13/2012	1/7/2014
	255,000	0.550%	12/10/2012	6/13/2014
	85,000	0.675%	12/3/2012	12/3/2014
	170,000	0.675%	12/6/2012	12/8/2014
	765,000			
2017	500,000	4.665%	3/2/2007	3/2/2017
	\$ 1,311,573	2.129%		

None of the structured repurchase agreements referred to above with maturity dates up to the date of this report were renewed.

Advances from the Federal Home Loan Bank

Advances are received from the FHLB under an agreement whereby the Company is required to maintain a minimum amount of qualifying collateral with a fair value of at least 110% of the outstanding advances. At June 30, 2013 and December 31, 2012, these advances were secured by mortgage and commercial loans amounting to \$1.3 billion both periods. Also, at June 30, 2013, the Company had an additional borrowing capacity with the FHLB of \$714.4 million. At June 30, 2013 and December 31, 2012, the weighted average remaining maturity of FHLB's advances was 11.7 months and 3.5 months, respectively. The original terms of these advances range between one month and five years, and the FHLB does not have the right to exercise put options at par on any advances outstanding as of June 30, 2013. The following table shows a summary of these advances and their terms, excluding accrued interest in the amount of \$294 thousand, at June 30, 2013:

Weighted-

Year of Maturity		Borrowing Balance	Average Coupon	Settlement Date	Maturity Date
		(In thousands)			
2013	\$	25,000	0.360%	6/4/2013	7/5/2013
		50,000	0.360%	6/10/2013	7/10/2013
		100,000	0.390%	6/17/2013	7/16/2013
		25,000	0.400%	6/24/2013	7/24/2013
		25,000	0.410%	6/28/2013	7/30/2013
		225,000			
2017		4,844	1.240%	4/3/2012	4/3/2017
2018		30,000	2.187%	1/16/2013	1/16/2018
		25,000	2.177%	1/16/2013	1/16/2018
		55,000			
	\$	284,844	0.745%		

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

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Subordinated Capital Notes

Subordinated capital notes amounted to \$99.0 million and \$146.0 million at June 30, 2013 and December 31, 2012, respectively.

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

The proceeds from this issuance were used by the Statutory Trust II to purchase a like amount of a floating rate junior subordinated deferrable interest debenture issued by the Company. The subordinated deferrable interest debenture has a par value of \$36.1 million, bears interest based on 3-month LIBOR plus 295 basis points (3.22% at June 30, 2013; 3.26% at December 31, 2012), is payable quarterly, and matures on September 17, 2033. It may be called at par after five years and quarterly thereafter (next call date September 2013). The trust redeemable preferred securities have the same maturity and call provisions as the subordinated deferrable interest debenture. The subordinated deferrable interest debenture issued by the Company is accounted for as a liability denominated as a subordinated capital note on the unaudited consolidated statements of financial condition.

Under Federal Reserve Board rules, restricted core capital elements, which are qualifying trust preferred securities, qualifying cumulative perpetual preferred stock (and related surplus) and certain minority interests in consolidated subsidiaries, are limited in the aggregate to no more than 25% of a bank holding company's core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability. However, under the Dodd-Frank Act, and the capital rules adopted in July 2013 by the federal banking regulators to implement the agreements reached by the Basel Committee on Banking Supervision in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" and to make other changes consistent with the Dodd-Frank Act, which are scheduled to become effective January 1, 2015 (subject to certain phase-in periods through January 1, 2019), bank holding companies are prohibited from including in their Tier 1 capital hybrid debt and equity securities, including trust preferred securities, issued on or after May 19, 2010. Any such instruments issued before May 19, 2010 by a bank holding company, such as the Company, with total consolidated assets of less than \$15 billion as of December 31, 2009, are permanently grandfathered under the new capital rules and may continue to be included as Tier 1 capital. Therefore, the Company is permitted to continue to include its existing trust preferred securities as Tier 1 capital.

As part of the BBVAPR Acquisition on December 18, 2012, the Company's banking subsidiary assumed three subordinated capital notes issued by BBVAPR Bank consisting of the following:

- Subordinated capital notes issued in September 2004 amounting to \$50.0 million at a variable rate of three-month LIBOR plus 1.44% (1.75% at December 31, 2012), that was due September 23, 2014. During the quarter ended March 31, 2013, the Bank repurchased and cancelled these subordinated capital notes in whole before maturity and realized a gain of \$1.1 million in the Company's unaudited consolidated statements of operations.
- Subordinated capital notes issued in September 2006 amounting to \$37.0 million at a fixed rate of 5.76% through September 29, 2011, and three-month LIBOR plus 1.56% thereafter (1.83% at June 30, 2013; 1.87% at December 31, 2012), due September 29, 2016. Interest on these subordinated notes is payable quarterly during the floating-rate period. The Bank has the option to redeem these subordinated capital notes in whole or in part from time to time before maturity at 100% of the principal amount plus any accrued but unpaid interest to the date of redemption, beginning September 29, 2011, and at each payment date thereafter.
- Subordinated capital notes issued in September 2006 amounting to \$30.0 million at a variable rate of three-month LIBOR plus 1.56% thereafter (1.83% at June 30, 2013; 1.87% at December 31, 2012), due September 29, 2016. Interest on these subordinated notes is payable quarterly. The Bank has the option to redeem these subordinated capital notes in whole or in part from time to time before maturity at 100% of the principal amount plus any accrued but unpaid interest to the date of redemption, beginning September 29, 2011, and at each payment date thereafter.

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

These notes qualify as Tier 2 capital at a discounted rate, which totals \$40.2 million at June 30, 2013 and \$50.2 million at December 31, 2012. Generally speaking, subordinated notes are included as Tier 2 capital if they have an original weighted average maturity of at least 5 years and comply with certain other requirements. As the notes approach maturity, they begin to take on characteristics of a short term obligation. For this reason, the outstanding amount eligible for inclusion in Tier 2 capital is reduced, or discounted, as the instruments approach maturity: one fifth of the outstanding amount is excluded each year during the instruments last five years before maturity. When the remaining maturity is less than one year, the instrument is excluded from Tier 2 capital.

Under the requirements of Puerto Rico Banking Act, the Bank must establish a redemption fund for the subordinated capital notes by transferring from undivided profits pre-established amounts as follows:

	Redemption fund (In thousands)
2013	\$ 48,575
2014	6,700
2015	6,700
2016	5,025
	\$ 67,000

Other borrowings

Other borrowings, presented in the unaudited consolidated statements of financial condition within “Advances from FHLB and other borrowings”, amounted to \$37.2 million and \$17.6 million at June 30, 2013 and December 31, 2012, respectively. These borrowings mainly consists of federal funds purchased of \$29.4 million and \$9.9 million at June 30, 2013 and December 31, 2012, respectively, with a weighted average interest rate of 0.30% at both dates, and unsecured fixed-rate borrowings of \$7.7 million at both June 30, 2013 and December 31, 2012, with a weighted average interest rate of 0.67% at both dates.

NOTE 11 — RELATED PARTY TRANSACTIONS

The Bank grants loans to its directors, executive officers and to certain related individuals or organizations in the ordinary course of business. These loans are offered at the same terms as loans to unrelated third parties. As of June 30, 2013 and December 31, 2012, these loan balances amounted to \$8.0 million and \$6.1 million, respectively. The activity and balance of these loans for the quarters and six-month periods ended June 30, 2013 and 2012 were as follows:

	Quarter Ended June 30,		Six-Month Period Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
Balance at the beginning of period	\$ 8,688	\$ 5,238	\$ 6,055	\$ 3,772
New loans	-	-	4,234	1,505
Repayments	(657)	(180)	(2,026)	(219)
Credits of persons no longer considered related parties	-	-	(232)	-
Balance at the end of period	\$ 8,031	\$ 5,058	\$ 8,031	\$ 5,058

OFG BANCORP**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)****NOTE 12 — INCOME TAXES**

On June 30, 2013 the Governor signed Act No. 40 known as “Ley de Redistribución y Ajuste de la Carga Contributiva” (Act of Redistribution and Adjustment of Tax Burden). This Act, along with others signed by the Governor, comprises the budget of the Commonwealth of Puerto Rico for 2013-2014. The main purpose of the Act is to increase government collections in order to alleviate the structural deficit. The most relevant provisions of the Act, as applicable to the Company, and effective for taxable years beginning after December 31, 2012 are as follows: (1) the maximum Corporate Income Tax rate was increased from 30% to 39%; (2) the allowance deduction for determining the income subject to surtax was reduced from \$750,000 to \$75,000 (which must be allocated among the members of a controlled group of corporations); (3) the allowable Net Operating Loss (“NOL”) deduction was reduced to (i) 90% of the corporation’s net income subject to regular tax, for purposes of computing the regular income tax and (ii) 80% of the alternative minimum taxable income for purposes of computing the alternative minimum tax (“AMT”); (4) the NOL carryover period was extended from 10 to 12 years for NOLs incurred after December 31, 2012; (5) a new special tax based on gross income (the “Special Tax”) was added to the Puerto Rico Internal Revenue Code of 2011, as further described below; and (6) a special tax of 1% on insurance premiums earned after June 30, 2013.

In the case of non-financial institutions, the Special Tax is paid as part of the AMT and thus is accounted for under the provisions of ASC 740. The applicable rate for non-financial institutions increases gradually from 0.2% for gross income in excess of \$1.0 million up to 0.85% for gross income in excess of \$1.5 billion. In the case of a controlled group of corporations, the tax rate for all members of the group is determined by the aggregate gross income of all members in the group. In the case of financial institutions, the Special Tax is not part of the AMT calculation thus is accounted for as other tax not subject to the provisions of ASC 740 since the same is based on gross income. The applicable rate for financial institutions is 1%, of which fifty percent (50%) may be claimed as a credit against the financial institution’s applicable income tax.

At June 30, 2013 and December 31, 2012, the Company’s net deferred tax asset amounted to \$155.2 million and \$122.5 million, respectively. Income tax benefit for the quarter and six-month periods ended June 30, 2013 totaled \$31.9 million and \$24.8 million, respectively. The benefit of both periods is related to the positive effect on the deferred tax asset of the increase in the enacted tax rate from 30% to 39%. Income tax expense for the quarter and six-month period ended June 30, 2012 totaled \$1.1 million and \$3.0 million, respectively.

At June 30, 2013 and December 31, 2012, OIB had \$415 thousand and \$504 thousand, respectively, in the income tax effect of unrecognized gain on available-for-sale securities included in other comprehensive income. Following the change in OIB’s applicable tax rate from 5% to 0% as a result of a Puerto Rico law adopted in 2011, this remaining tax balance will flow through income as these securities are repaid or sold in future periods. During the quarters ended June 30, 2013 and 2012, \$43 thousand and \$166 thousand, respectively, related to this residual tax effect from OIB was reclassified from accumulated other comprehensive income into income tax provision. During the six-month periods ended June 30, 2013 and 2012, \$89 thousand and \$724 thousand, respectively, related to this residual effect

from OIB was reclassified from accumulated other comprehensive income to income tax provision.

The Company maintained an effective tax rate for the six-month period ended June 30, 2013 lower than the new maximum marginal statutory rate of 39.00%. The reconciliation of the enacted tax rate and the effective income tax rate for the six-month period ended June 30, 2013 follows:

	Six-Month Period Ended June 30, 2013	
	Amount	Rate
	(Dollars in thousands)	
Tax at statutory rates	\$ 13,230	39.00%
Tax effect of exempt income, net	(3,607)	-10.63%
Effect in deferred taxes due to increase in tax rates from 30.00% to 39.00%	(36,928)	-108.85%
Other items, net	2,497	7.35%
Income tax benefit	\$ (24,808)	-73.13%

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Company classifies unrecognized tax benefits in income taxes payable. These gross unrecognized tax benefits would affect the effective tax rate if realized. The balance of unrecognized tax benefits at June 30, 2013 was \$5.6 million (December 31, 2012 - \$5.3 million). The Company had accrued \$1.7 million at June 30, 2013 (December 31, 2012 - \$1.4 million) for the payment of interest and penalties relating to unrecognized tax benefits. As part of the BBVAPR Acquisition, there are unrecognized tax benefits amounting to \$3.9 million at June 30, 2013 and December 31, 2012. There is also \$812 thousand (December 31, 2012 - \$665 thousand) in accrued payment of interest and penalties relating to unrecognized tax benefits.

NOTE 13 — STOCKHOLDERS' EQUITY AND EARNINGS PER COMMON SHARE

Regulatory Capital Requirements

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by federal and Puerto Rico banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Pursuant to the Dodd-Frank Act, federal banking regulators have adopted new capital rules that are scheduled to become effective January 1, 2015 (subject to certain phase-in periods through January 1, 2019) and that will replace their general risk-based capital rules, advanced approaches rule, market risk rule, and leverage rules.

Quantitative measures established by regulation to ensure capital adequacy currently require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations) and of Tier 1 capital to average assets (as defined in the regulations). As of June 30, 2013 and December 31, 2012, the Company and the Bank met all capital adequacy requirements to which they are subject. As of June 30, 2013 and December 31, 2012, the Bank is "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The Company's and the Bank's actual capital amounts and ratios as of June 30, 2013 and December 31, 2012 are as follows:

	Actual		Minimum Capital Requirement	
	Amount	Ratio	Amount	Ratio
(Dollars in thousands)				
Company Ratios				
<u>As of June 30, 2013</u>				
Total capital to risk-weighted assets	\$ 807,190	15.83%	\$ 407,818	8.00%
Tier 1 capital to risk-weighted assets	\$ 702,801	13.79%	\$ 203,909	4.00%
Tier 1 capital to total assets	\$ 702,801	8.54%	\$ 329,223	4.00%
<u>As of December 31, 2012</u>				
Total capital to risk-weighted assets	\$ 794,195	15.15%	\$ 419,269	8.00%
Tier 1 capital to risk-weighted assets	\$ 678,127	12.94%	\$ 209,634	4.00%
Tier 1 capital to total assets	\$ 678,127	6.42%	\$ 422,307	4.00%

	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
Bank Ratios						
<u>As of June 30, 2013</u>						
Total capital to risk-weighted assets	\$ 743,653	15.01%	\$ 396,291	8.00%	\$ 495,363	10.00%
Tier 1 capital to risk-weighted assets	\$ 641,043	12.94%	\$ 198,145	4.00%	\$ 297,218	6.00%
Tier 1 capital to total assets	\$ 641,043	7.84%	\$ 327,058	4.00%	\$ 408,823	5.00%
<u>As of December 31, 2012</u>						
Total capital to risk-weighted assets	\$ 719,675	14.03%	\$ 410,268	8.00%	\$ 512,835	10.00%
Tier 1 capital to risk-weighted assets	\$ 604,997	11.80%	\$ 205,134	4.00%	\$ 307,701	6.00%
Tier 1 capital to total assets	\$ 604,997	5.76%	\$ 420,298	4.00%	\$ 525,373	5.00%

Additional paid-in capital

Additional paid-in capital represents contributed capital in excess of par value of common and preferred stock net of costs of the issuance. As of June 30, 2013, accumulated issuance costs charged against additional paid in capital amounted to \$10.1 million and \$13.6 million for preferred and common stock, respectively.

Legal Surplus

The Puerto Rico Banking Act requires that a minimum of 10% of the Bank's net income for the year be transferred to a reserve fund until such fund (legal surplus) equals the total paid in capital on common and preferred stock. At June 30, 2013 and December 31, 2012, the Bank's legal surplus amounted to \$57.9 million and \$52.1 million, respectively. The amount transferred to the legal surplus account is not available for the payment of dividends to shareholders.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Earnings per Common Share

The calculation of earnings per common share for the quarters and six-month periods ended June 30, 2013 and 2012 is as follows:

		Quarter Ended June 30,		Six-Month Period Ended June	
		2013	2012	2013	2012
		(In thousands, except per share data)			
Net income	\$	37,539	\$ 14,958	\$ 58,731	\$ 25,610
Less: Dividends on preferred stock					
Non-Convertible Preferred Stock					
(Series A, B, and D)		(1,629)	(1,201)	(3,256)	(2,401)
Convertible preferred stock (Series					
C)		(1,837)	-	(3,675)	-
Income available to common					
shareholders	\$	34,073	\$ 13,757	\$ 51,800	\$ 23,209
Effect of assumed conversion of the					
Convertible Preferred Stock		1,837	-	3,675	-
Income available to common					
shareholders assuming					
conversion	\$	35,910	\$ 13,757	\$ 55,475	\$ 23,209
Weighted average common shares					
and share equivalents:					
Average common shares outstanding		45,630	40,703	45,613	40,873
Effect of dilutive securities:					
Average potential common					
shares-options		200	105	178	113
Average potential common					
shares-assuming					
conversion of convertible preferred					
stock		7,138	-	7,138	-
Total weighted average common					
shares outstanding					
and equivalents		52,968	40,808	52,929	40,986
Earnings per common share - basic	\$	0.75	\$ 0.34	\$ 1.14	\$ 0.57
Earnings per common share - diluted	\$	0.68	\$ 0.34	\$ 1.05	\$ 0.57

In computing diluted earnings per common share, the 84,000 shares of convertible preferred stock, which remained outstanding at June 30, 2013, with a conversion rate, subject to certain conditions, of 84.9798 shares of common stock per share, were included as average potential common shares from the date they were issued and outstanding. Moreover, in computing diluted earnings per common share, the dividends declared during the quarter and six-month period ended June 30, 2013 on the convertible preferred stock were added back as income available to common shareholders.

For the quarters ended June 30, 2013 and 2012, weighted-average stock options with an anti-dilutive effect on earnings per share not included in the calculation amounted to 243,721 and 708,976, respectively. For the six-month periods ended June 30, 2013 and 2012, weighted-average stock options with an anti-dilutive effect on earnings per share not included in the calculation amounted to 578,393 and 707,143, respectively.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Treasury Stock

Repurchased common stock is held by the Company as treasury shares. The Company records treasury stock purchases under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock.

The activity in connection with common shares held in treasury by the Company for the six-month periods ended June 30, 2013 and 2012 is set forth below:

	Six-Month Period Ended June 30,		2012	
	2013			
	Shares	Dollar Amount	Shares	Dollar Amount
	(In thousands, except shares data)			
Beginning of period	7,090,597	\$ 81,275	6,564,124	\$ 74,808
Common shares used upon lapse of restricted stock units	(34,800)	(364)	(37,446)	(392)
Common shares repurchased as part of the stock repurchase program	-	-	603,000	7,022
Common shares used to match defined contribution plan, net	(7,318)	(77)	(18,898)	(35)
End of period	7,048,479	\$ 80,834	7,110,780	\$ 81,403

Accumulated Other Comprehensive Income

Accumulated other comprehensive income, net of income tax, as of June 30, 2013 and December 31, 2012 consisted of:

	June 30,	December 31,
	2013	2012
	(In thousands)	
Unrealized gain on securities available-for-sale which are not	\$ 28,779	\$ 75,347

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other-than-temporarily impaired		
Income tax effect of unrealized gain on securities available-for-sale	(3,379)	(7,102)
Net unrealized gain on securities available-for-sale which are not		
other-than-temporarily impaired	25,400	68,245
Unrealized loss on cash flow hedges	(13,187)	(17,664)
Income tax effect of unrealized loss on cash flow hedges	3,553	5,299
Net unrealized loss on cash flow hedges	(9,634)	(12,365)
	\$ 15,766	\$ 55,880

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The following table presents changes in accumulated other comprehensive income by component, net of taxes, for the quarter and the six-month period ended June 30, 2013:

	Quarter Ended June 30, 2013			Six-Month Period Ended June 30, 2013		
	Net unrealized gains on securities available-for-sale	Net unrealized loss on cash flow hedges	Accumulated other comprehensive income	Net unrealized gains on securities available-for-sale	Net unrealized loss on cash flow hedges	Accumulated other comprehensive income
	(In thousands)			(In thousands)		
Beginning balance	\$ 58,393	\$ (11,342)	\$ 47,051	\$ 68,245	\$ (12,365)	\$ 55,880
Other comprehensive income before reclassifications	(33,036)	292	(32,744)	(42,934)	(21)	(42,955)
Amounts reclassified out of accumulated other comprehensive income	43	1,416	1,459	89	2,752	2,841
Other comprehensive income (loss)	(32,993)	1,708	(31,285)	(42,845)	2,731	(40,114)
Ending balance	\$ 25,400	\$ (9,634)	\$ 15,766	\$ 25,400	\$ (9,634)	\$ 15,766

The following table presents reclassifications out of accumulated other comprehensive income for the quarter and six-month period ended June 30, 2013:

	Quarter Ended June 30, 2013 (In thousands)	Six-Month Period Ended June 30, 2013 (In thousands)	Affected Line Item in Consolidated Statement of Operations
Cash flow hedges:			
Interest-rate contracts	\$ 1,416	\$ 2,752	Net interest expense
Available-for-sale securities:			

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Residual tax effect from OIB's change in applicable tax rate	43	89	Income tax expense
	\$ 1,459	\$ 2,841	

At June 30, 2013 and December 31, 2012, OIB had \$415 thousand and \$504 thousand, respectively, in the income tax effect of unrecognized gain on available-for-sale securities included in other comprehensive income. Following the change in OIB's applicable tax rate from 5% to 0% as a result of a new Puerto Rico law adopted in 2011, this remaining tax balance will flow through income as these securities are repaid or sold in future periods.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 14 — COMMITMENTS

Loan Commitments

In the normal course of business, the Company becomes a party to credit-related financial instruments with off-balance-sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby and commercial letters of credit, and financial guarantees. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the unaudited consolidated statements of financial condition. The contract or notional amount of those instruments reflects the extent of the Company's involvement in particular types of financial instruments.

The Company's exposure to credit losses in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit, including commitments under credit card arrangements, and commercial letters of credit is represented by the contractual notional amount of those instruments, which do not necessarily represent the amounts potentially subject to risk. In addition, the measurement of the risks associated with these instruments is meaningful only when all related and offsetting transactions are identified. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Summarized credit-related financial instruments at June 30, 2013 and December 31, 2012 were as follows:

	June 30, 2013	December 31, 2012
	(In thousands)	
Commitments to extend credit	\$ 445,411	\$ 591,679
Commercial letters of credit	2,231	2,918

Commitments from loans acquired as part of the BBVAPR Acquisition amounted to \$337.1 million and \$461.6 million at June 30, 2013 and December 31, 2012, respectively. Commitments to extend credit represent agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Company upon the extension of credit, is based on management's credit evaluation of the counterparty.

At June 30, 2013 and December 31, 2012, commitments to extend credit consisted mainly of undisbursed available amounts on commercial lines of credit, construction loans, and revolving credit card arrangements. Since many of the unused commitments are expected to expire unused or be only partially used, the total amount of these unused

commitments does not necessarily represent future cash requirements. These lines of credit had a reserve of \$900 thousand at both June 30, 2013 and December 31, 2012.

Commercial letters of credit are issued or confirmed to guarantee payment of customers' payables or receivables in short-term international trade transactions. Generally, drafts will be drawn when the underlying transaction is consummated as intended. However, the short-term nature of this instrument serves to mitigate the risk associated with these contracts.

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

The summary of instruments that are considered financial guarantees in accordance with the authoritative guidance related to guarantor's accounting and disclosure requirements for guarantees, including indirect guarantees of indebtedness of others, at June 30, 2013 and December 31, 2012, is as follows:

	June 30, 2013	December 31, 2012
	(In thousands)	
Standby letters of credit and financial guarantees	\$ 67,087	\$ 69,789
Loans sold with recourse	184,937	172,492
Commitments to sell or securitize mortgage loans	10,977	83,663

Standby letters of credit and financial guarantees are written conditional commitments issued by the Company to guarantee the payment and/or performance of a customer to a third party ("beneficiary"). If the customer fails to comply with the agreement, the beneficiary may draw on the standby letter of credit or financial guarantee as a remedy. The amount of credit risk involved in issuing letters of credit in the event of nonperformance is the face amount of the letter of credit or financial guarantee. These guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The amount of collateral obtained, if it is deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. The Company does not expect any significant losses under these obligations. As of June 30, 2013 and December 31, 2012, no performance was required on any financial guarantees. As part of the BBVAPR Acquisition, the Company assumed \$65.9 million of standby letters of credit and \$169.3 million of loans sold without recourse commitments at December 31, 2012.

Lease Commitments

The Company has entered into various operating lease agreements for branch facilities and administrative offices. Rent expense for the quarters ended June 30, 2013 and 2012 amounted to \$2.6 million and \$1.6 million, respectively, and is included in the "occupancy and equipment" caption in the unaudited consolidated statements of operations. For the six-month periods ended June 30, 2013 and 2012, rent expense amounted to \$5.2 million and \$3.3 million, respectively. Future rental commitments under leases in effect at June 30, 2013, exclusive of taxes, insurance, and maintenance expenses payable by the Company, are summarized as follows:

Year Ending June 30,**Minimum Rent
(In thousands)**

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2013	\$	5,332
2014		8,402
2015		8,116
2016		7,492
2017		7,965
Thereafter	\$	24,755
		62,062

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

NOTE 15 — CONTINGENCIES

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

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

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

NOTE 16 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company follows the fair value measurement framework under GAAP.

Fair Value Measurement

The fair value measurement framework defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This framework also establishes a fair value

hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs previously described that may be used to measure fair value.

Money market investments

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

Investment securities

The fair value of investment securities is based on quoted market prices, when available, or market prices provided by recognized broker-dealers. If listed prices or quotes are not available, fair value is based upon externally developed models that use both observable and unobservable inputs depending on the market activity of the instrument. The Company holds two securities categorized as other debt that are classified as Level 3. The estimated fair value of the other debt securities is determined by using a third-party model to calculate the present value of projected future cash flows. The assumptions are highly uncertain and include primarily market discount rates, current spreads, and an indicative pricing. The assumptions used are drawn from similar securities that are actively traded in the market and have similar characteristics as the collateral underlying the debt securities being evaluated. The valuation is performed on a monthly basis.

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Derivative instruments

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

Certain other derivative instruments with limited market activity are valued using externally developed models that consider unobservable market parameters. Based on their valuation methodology, derivative instruments are classified as Level 2 or Level 3. The Company has offered its customers certificates of deposit with an option tied to the performance of the S&P Index and uses equity indexed option agreements with major broker-dealers to manage its exposure to changes in this index. Their fair value is obtained through the use of an external based valuation that was thoroughly evaluated and adopted by management as its measurement tool for these options. The payoff of these options is linked to the average value of the S&P Index on a specific set of dates during the life of the option. The methodology uses an average rate option or a cash-settled option whose payoff is based on the difference between the expected average value of the S&P Index during the remaining life of the option and the strike price at inception. The assumptions, which are uncertain and require a degree of judgment, include primarily S&P Index volatility, forward interest rate projections, estimated index dividend payout, and leverage.

Servicing assets

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

Loans receivable considered impaired that are collateral dependent

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

Foreclosed real estate

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

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

	June 30, 2013				Total
	Level 1	Fair Value Measurements		Level 3	
		Level 2		Level 3	
		(In thousands)			
Recurring fair value measurements:					
Investment securities available-for-sale	\$	-	\$ 1,816,172	\$ 20,057	\$ 1,836,229
Money market investments		10,983	-	-	10,983
Derivative assets		-	3,635	16,020	19,655
Servicing assets		-	-	12,994	12,994
Derivative liabilities		-	(16,701)	(15,315)	(32,016)
	\$	10,983	\$ 1,803,106	\$ 33,756	\$ 1,847,845
Non-recurring fair value measurements:					
Impaired commercial loans	\$	-	-	\$ 43,831	\$ 43,831
Foreclosed real estate		-	-	81,689	81,689
	\$	-	\$ -	\$ 125,520	\$ 125,520

	December 31, 2012				Total
	Level 1	Fair Value Measurements		Level 3	
		Level 2		Level 3	
		(In thousands)			
Recurring fair value measurements:					
Investment securities available-for-sale	\$	-	\$ 2,174,274	\$ 20,012	\$ 2,194,286
Securities purchased under agreements to resell		-	80,000	-	80,000
Money market investments		13,205	-	-	13,205
Derivative assets		-	8,656	13,233	21,889
Servicing assets		-	-	10,795	10,795
Derivative liabilities		-	(26,260)	(12,707)	(38,967)
	\$	13,205	\$ 2,236,670	\$ 31,333	\$ 2,281,208
Non-recurring fair value measurements:					
Impaired commercial loans	\$	-	-	\$ 46,199	\$ 46,199
Foreclosed real estate		-	-	75,447	75,447
	\$	-	\$ -	\$ 121,646	\$ 121,646

OFG BANCORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the quarters and the six-month periods ended June 30, 2013 and 2012:

Level 3 Instruments Only	Quarter Ended June 30, 2013					Total
	Other debt securities available-for-sale	Derivative asset (S&P Purchased Options)	Servicing assets	Derivative liability (S&P Embedded Options)		
Balance at beginning of period	\$ 20,042	\$ 15,404	\$ 11,543	\$ (14,839)	\$ 32,150	
Gains (losses) included in earnings	-	616	-	(516)	100	
Changes in fair value of investment securities available for sale included						
in other comprehensive income	16	-	-	-	16	
New instruments acquired	-	-	1,301	-	1,301	
Principal repayments	-	-	(489)	-	(489)	
Amortization	-	-	-	40	40	
Changes in fair value of servicing assets	-	-	639	-	639	
Balance at end of period	\$ 20,058	\$ 16,020	\$ 12,994	\$ (15,315)	\$ 33,757	

Level 3 Instruments Only	Quarter Ended June 30, 2012					Total
	Investment securities available-for-sale CLOs	Other debt securities	Derivative asset (S&P Purchased Options)	Servicing assets	Derivative liability (S&P Embedded Options)	
Balance at beginning of period	\$ 29,643	\$ 9,882	\$ 12,515	\$ 10,725	\$ (12,138)	\$ 50,627

