SunCoke Energy, Inc.
Form 10-Q
October 30, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 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 001-35243

SUNCOKE ENERGY, INC.

(Exact name of registrant as specified in its charter)

Delaware	90-0640593
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1011 Warrenville Road, Suite 600
Lisle, Illinois 60532
(630) 824-1000
(Registrant's telephone number, including area code)

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. ý Yes ¨ 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). ý Yes ¨ No

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

Large accelerated filer	ý	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨

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

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As of October 25, 2013, there were 69,580,319 shares of the Registrant's $0.01 par value Common Stock outstanding.

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PART I – FINANCIAL INFORMATION

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PART I – FINANCIAL INFORMATION
SunCoke Energy, Inc.
Consolidated Statements of Income
(Unaudited)
Item 1. Consolidated Financial Statements

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars and shares in millions, except per share amounts)			
Revenues				
Sales and other operating revenue	$389.9	$480.1	$1,245.0	$1,421.4
Other income, net	0.6	0.4	3.1	1.3
Total revenues	390.5	480.5	1,248.1	1,422.7
Costs and operating expenses				
Cost of products sold and operating expenses	316.5	388.9	1,031.3	1,174.6
Selling, general and administrative expenses	23.5	20.0	65.9	61.2
Depreciation, depletion and amortization	23.2	18.9	70.5	57.5
Total costs and operating expenses	363.2	427.8	1,167.7	1,293.3
Operating income	27.3	52.7	80.4	129.4
Interest expense, net	12.1	12.2	40.0	36.0
Income before income tax expense and loss from equity method investment	15.2	40.5	40.4	93.4
Income tax expense	0.6	7.6	6.5	19.9
Loss from equity method investment	2.3	—	2.5	—
Net income	12.3	32.9	31.4	73.5
Less: Net income attributable to noncontrolling interests	6.1	1.3	17.4	2.3
Net income attributable to SunCoke Energy, Inc.	$6.2	$31.6	$14.0	$71.2
Earnings attributable to SunCoke Energy, Inc. per common share:				
Basic	$0.09	$0.45	$0.20	$1.02
Diluted	$0.09	$0.45	$0.20	$1.01
Weighted average common shares outstanding:				
Basic	69.8	70.0	69.9	70.0
Diluted	70.0	70.3	70.2	70.3

(See Accompanying Notes)

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SunCoke Energy, Inc.
Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in millions)			
Net income	$12.3	$32.9	$31.4	$73.5
Other comprehensive loss:				
Reclassifications of prior service benefit and actuarial loss amortization to earnings (net of related tax expense of $0.2 million and $0.9 million for the three and nine months ended September 30, 2013, respectively, and $0.3 million and $0.9 million for the three and nine months ended September 30, 2012, respectively)	(0.5)	(0.6)	(1.5)	(1.5)
Currency translation adjustment	(10.1)	—	(13.5)	(0.9)
Comprehensive income	1.7	32.3	16.4	71.1
Less: Comprehensive income attributable to noncontrolling interests	6.1	1.3	17.4	2.3
Comprehensive income (loss) attributable to SunCoke Energy, Inc.	$(4.4)	$31.0	$(1.0)	$68.8

(See Accompanying Notes)

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SunCoke Energy, Inc.
Consolidated Balance Sheets

	September 30, 2013 (Unaudited)	December 31, 2012
	(Dollars in millions, except per share amounts)	
Assets		
Cash and cash equivalents	$268.8	$ 239.2
Receivables	65.9	70.0
Inventories	134.5	160.1
Income tax receivable	3.7	—
Deferred income taxes	2.6	2.6
Total current assets	475.5	471.9
Investment in Brazil cokemaking operations	41.0	41.0
Equity method investment in VISA SunCoke Limited	52.5	—
Properties, plants and equipment, net	1,451.2	1,396.6
Lease and mineral rights, net	52.2	52.5
Goodwill	9.4	9.4
Deferred charges and other assets	40.9	39.6
Total assets	$2,122.7	$ 2,011.0
Liabilities and Equity		
Accounts payable	$125.8	$ 132.9
Current portion of long-term debt	0.8	3.3
Accrued liabilities	60.9	91.2
Interest payable	7.8	15.7
Income taxes payable	—	3.9
Total current liabilities	195.3	247.0
Long-term debt	648.3	720.1
Obligation for black lung benefits	34.1	34.8
Retirement benefit liabilities	40.9	42.5
Deferred income taxes	362.4	361.5
Asset retirement obligations	16.7	13.5
Other deferred credits and liabilities	17.9	16.7
Total liabilities	1,315.6	1,436.1
Equity		
Preferred stock, $0.01 par value. Authorized 50,000,000 shares; no issued and outstanding shares at September 30, 2013 and December 31, 2012	—	—
Common stock, $0.01 par value. Authorized 300,000,000 shares; issued and outstanding 69,524,424 and 69,988,728 shares at September 30, 2013 and December 31, 2012, respectively	0.7	0.7
Treasury stock, 1,255,355 shares at September 30, 2013 and 603,528 at December 31, 2012	(19.9)	(9.4)
Additional paid-in capital	443.4	436.9
Accumulated other comprehensive loss	(22.9)	(7.9)
Retained earnings	132.8	118.8
Total SunCoke Energy, Inc. stockholders' equity	534.1	539.1

Noncontrolling interests	273.0	35.8
Total equity	807.1	574.9
Total liabilities and equity	$2,122.7	$ 2,011.0

(See Accompanying Notes)

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SunCoke Energy, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
	(Dollars in millions)	
Cash Flows from Operating Activities:		
Net income	$31.4	$73.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	70.5	57.5
Deferred income tax expense	1.2	39.2
Payments in excess of expense for retirement plans	(1.6)	(6.2)
Share-based compensation expense	5.5	5.1
Loss from equity method investment	2.5	—
Changes in working capital pertaining to operating activities, net of acquisition:		
Receivables	4.1	(24.9)
Inventories	28.3	27.0
Accounts payable	(7.1)	(60.9)
Accrued liabilities	(30.3)	10.2
Interest payable	(7.9)	(7.8)
Income taxes	(7.3)	(23.6)
Other	(1.7)	(11.3)
Net cash provided by operating activities	87.6	77.8
Cash Flows from Investing Activities:		
Capital expenditures	(95.6)	(40.6)
Acquisition of business	(28.6)	—
Equity method investment in VISA SunCoke Limited	(67.7)	—
Net cash used in investing activities	(191.9)	(40.6)
Cash Flows from Financing Activities:		
Proceeds from issuance of common units of SunCoke Energy Partners, L.P., net of offering costs	237.8	—
Proceeds from issuance of long-term debt	150.0	—
Debt issuance costs	(6.9)	—
Repayment of long-term debt	(225.0)	(2.5)
Proceeds from exercise of stock options	0.9	4.7
Repurchase of common stock	(10.9)	(9.1)
Cash distribution to noncontrolling interest	(12.0)	—
Net cash provided by (used in) financing activities	133.9	(6.9)
Net increase in cash and cash equivalents	29.6	30.3
Cash and cash equivalents at beginning of period	239.2	127.5
Cash and cash equivalents at end of period	$268.8	$157.8

(See Accompanying Notes)

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SunCoke Energy, Inc.
Consolidated Statements of Equity
(Unaudited)

	Common Stock Shares	Common Stock Amount	Treasury Stock Shares	Treasury Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Total SunCoke Energy, Inc. Equity	Noncontrolling Interests	Total Equity
	(Dollars in millions)									
At December 31, 2011	70,012,702	$0.7	—	$—	$511.3	$(6.5)	$20.0	$525.5	$34.4	$559.9
Net income	—	—	—	—	—	—	71.2	71.2	2.3	73.5
Reclassifications of prior service benefit and actuarial loss amortization to earnings (net of related tax benefit of $0.6 million)	—	—	—	—	—	(1.5)	—	(1.5)	—	(1.5)
Currency translation adjustment	—	—	—	—	—	(0.9)	—	(0.9)	—	(0.9)
Noncash distribution to Sunoco under Tax Sharing Agreement	—	—	—	—	(88.2)	—	—	(88.2)	—	(88.2)
Share-based compensation expense	—	—	—	—	5.1	—	—	5.1	—	5.1
Stock options exercised and RSUs vested	535,143	—	—	—	4.7	—	—	4.7	—	4.7
Shares repurchased	(592,197)	—	592,197	(9.1)	—	—	—	(9.1)	—	(9.1)
Shares issued to directors	10,140	—	—	—	0.1	—	—	0.1	—	0.1
At September 30, 2012	69,965,788	$0.7	592,197	$(9.1)	$433.0	$(8.9)	$91.2	$506.9	$36.7	$543.6
At December 31, 2012	69,988,728	$0.7	603,528	$(9.4)	$436.9	$(7.9)	$118.8	$539.1	$35.8	$574.9
Net income	—	—	—	—	—	—	14.0	14.0	17.4	31.4
Reclassifications of prior service benefit and actuarial loss amortization to earnings (net of related tax benefit of $0.9 million)	—	—	—	—	—	(1.5)	—	(1.5)	—	(1.5)
Currency translation adjustment	—	—	—	—	—	(13.5)	—	(13.5)	—	(13.5)

Net proceeds from issuance of SunCoke Energy Partners, L.P. units	—	—	—	—	—	—	—	—	231.8	231.8
Cash distribution to noncontrolling interests	—	—	—	—	—	—	—	—	(12.0)	(12.0)
Share-based compensation expense	—	—	—	—	5.5	—	—	5.5	—	5.5
Stock options exercised and RSUs vested	163,859	—	—	—	1.3	—	—	1.3	—	1.3
Shares repurchased	(651,827)	—	651,827	(10.5)	(0.4)	—	—	(10.9)	—	(10.9)
Shares issued to directors	23,664	—	—	—	0.1	—	—	0.1	—	0.1
At September 30, 2013	69,524,424	$ 0.7	1,255,355	$ (19.9)	$ 443.4	$ (22.9)	$ 132.8	$ 534.1	$ 273.0	$ 807.1

(See Accompanying Notes)

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SunCoke Energy, Inc.
Notes to the Consolidated Financial Statements
1. General
Description of Business
SunCoke Energy, Inc. (“SunCoke Energy”, “Company”, "we", "our" and "us") is an independent owner and operator of five cokemaking facilities in the eastern and midwestern regions of the United States ("U.S.") and operator of a cokemaking facility for a project company in Brazil in which it has a preferred stock investment. The cokemaking operations include blast furnace coke manufacturing at the Company’s Jewell Coke Company, L.P. (“Jewell”) facility in Vansant, Virginia; Indiana Harbor Coke Company, L.P. (“Indiana Harbor”) facility in East Chicago, Indiana; Haverhill Coke Company (“Haverhill”) facility in Franklin Furnace, Ohio; Gateway Energy & Coke Company, LLC (“Granite City”) facility in Granite City, Illinois; and Middletown Coke Company, Inc. (“Middletown”) facility in Middletown, Ohio.
Our Consolidated Financial Statements include SunCoke Energy Partners, L.P. (the "Partnership"), a publicly-traded partnership and variable interest entity. We are considered to be the primary beneficiary of the Partnership for accounting purposes as we have the sole ability to direct the activities of the Partnership that most significantly impact its economic performance. See Note 3.
On August 30, 2013, the Partnership completed its acquisition of the assets and business operations of Lakeshore Coal Handling Corporation, a coal handling and blending service provider. See Note 5.
On March 18, 2013, we completed the transaction to form a cokemaking joint venture with VISA Steel Limited ("VISA Steel") in India called VISA SunCoke Limited ("VISA SunCoke"). VISA SunCoke is comprised of a 440 thousand ton heat recovery cokemaking facility and the facility's associated steam generation units in Odisha, India. See Note 4.
On January 17, 2012 (the “Distribution Date”), we became an independent, publicly-traded company following our separation (the "Separation") from Sunoco, Inc. (“Sunoco”). The Separation occurred in two steps:

- We were formed as a wholly-owned subsidiary of Sunoco in 2010. On July 18, 2011 (the “Separation Date”), Sunoco contributed the subsidiaries, assets and liabilities that were primarily related to its cokemaking and coal mining operations to us in exchange for shares of our common stock. As of such date, Sunoco owned 100 percent of our common stock. On July 26, 2011, we completed an initial public offering (“IPO”) of 13,340,000 shares of our common stock, or 19.1 percent of our outstanding common stock. Following the IPO, Sunoco continued to own 56,660,000 shares of our common stock, or 80.9 percent of our outstanding common stock.
- On the Distribution Date, Sunoco made a pro-rata, tax free distribution (the “Distribution”) of the remaining shares of our common stock that it owned in the form of a special stock dividend to Sunoco shareholders. Sunoco shareholders received 0.53046456 of a share of common stock for every share of Sunoco common stock held as of the close of business on January 5, 2012, the record date for the Distribution. After the Distribution, Sunoco ceased to own any shares of our common stock.

Quarterly Reporting
The accompanying Consolidated Financial Statements included herein have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) for interim reporting. Certain information and disclosures normally included in financial statements have been omitted pursuant to the rules and regulation of the Securities and Exchange Commission (“SEC”). In management’s opinion, all adjustments (which include only normal recurring adjustments) necessary for a fair presentation of the results of operations, financial position and cash flows for the periods presented have been made. The results of operations for the period ended September 30, 2013 are not necessarily indicative of the operating results for the full year.
Reclassifications
Certain amounts in the prior period Consolidated Financial Statements have been reclassified to conform to the current year presentation.

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New Accounting Standards
On January 1, 2013, we adopted Accounting Standards Update ("ASU") 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This ASU requires the disclosure of changes to accumulated other comprehensive income to be presented by component on the face of the financial statements or in a separate note to the financial statements. This ASU also requires the disclosure of significant items reclassified out of accumulated other comprehensive income to net income during the period either on the face of the financial statements or in a separate note to the financial statements. This standard is effective prospectively for interim and annual periods beginning after December 15, 2012. See Note 17.
2. Arrangements Between Sunoco and SunCoke Energy, Inc.
In connection with the IPO, SunCoke Energy and Sunoco entered into certain agreements that effected the separation of SunCoke Energy’s business from Sunoco, provided a framework for its relationship with Sunoco after the separation and provided for the allocation between SunCoke Energy and Sunoco of Sunoco’s assets, employees, liabilities and obligations attributable to periods prior to, at and after the Separation.
Tax Sharing Agreement. On the Separation Date, SunCoke Energy and Sunoco entered into a tax sharing agreement that governs the parties’ respective rights, responsibilities and obligations with respect to tax liabilities and benefits, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings and other matters regarding taxes. The tax sharing agreement expires on January 17, 2014. Upon and subsequent to the Separation, SunCoke Energy made noncash distributions of $88.2 million related to the settlement of tax attributes under the tax sharing agreement with Sunoco during the nine months ended September 30, 2012. A corresponding reduction was made to SunCoke Energy's equity accounts. See Note 6.
Transition Services Agreement. On the Separation Date, SunCoke Energy and Sunoco entered into a transition services agreement. The services provided under this agreement generally terminated upon completion of the Distribution on January 17, 2012. The fees paid to Sunoco under this agreement were not material to the financial statements for the three and nine months ended September 30, 2013 and 2012. We expect any remaining services under this agreement will be terminated by the end of 2013.
Guaranty, Keep Well, and Indemnification Agreement. On the Separation Date, SunCoke Energy and Sunoco entered into a guaranty, keep well, and indemnification agreement. Under this agreement, SunCoke Energy: (1) guarantees the performance of certain obligations of its subsidiaries, prior to the date that Sunoco or its affiliates may become obligated to pay or perform such obligations, including the repayment of a loan from Indiana Harbor Coke Company L.P.; (2) indemnifies, defends, and holds Sunoco and its affiliates harmless against all liabilities relating to these obligations; and (3) restricts the assets, debts, liabilities and business activities of one of its wholly-owned subsidiaries, so long as certain obligations of such subsidiary remain unpaid or unperformed. In addition, SunCoke Energy released Sunoco from its guaranty of payment of a promissory note owed by one of its subsidiaries to another of its subsidiaries.
3. Formation of a Master Limited Partnership
On January 24, 2013, we completed the initial public offering of the Partnership through the sale of 13,500,000 common units, representing limited partner interests in the Partnership in exchange for $231.8 million of proceeds, net of $24.7 million of offering costs, $6.0 million of which were paid during 2012 (the "Partnership offering"). Of these net proceeds, $67.0 million was retained by the Partnership for environmental remediation capital expenditures and $12.4 million for sales discounts related to tax credits owed to our customers. Upon the closing of the Partnership offering, we own the general partner of the Partnership, which consists of a 2.0 percent ownership interest and incentive distribution rights, and a 55.9 percent limited partner interest in the Partnership. The key assets of the Partnership are a 65 percent interest in each of our Haverhill and Middletown cokemaking and heat recovery facilities. We are also party to an omnibus agreement pursuant to which we will provide the Partnership with: (1) remarketing efforts upon the occurrence of certain potential adverse events under our coke sales agreements; (2) indemnification of certain environmental costs; and (3) preferential rights for growth opportunities.
In connection with the closing of the Partnership offering, we entered into an amendment to our Credit Agreement and the Partnership repaid $225.0 million of our Term Loan and issued $150.0 million of senior notes ("Partnership Notes"). See Note 10.

As the general partner of the Partnership, we have the sole ability to direct the activities of the Partnership that most significantly impact its economic performance. We are also considered to be the primary beneficiary of the Partnership for accounting purposes and consolidate the results of the Partnership in our results. The Partnership's Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012, as presented below, are included in the Consolidated Balance Sheets of SunCoke Energy.

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	SunCoke Energy Partners, L.P. September 30, 2013 (Unaudited)	SunCoke Energy Partners, L.P. Predecessor December 31, 2012
	(Dollars in millions)	
Assets		
Cash	$78.5	$—
Receivables	26.0	27.4
Inventories	57.9	63.2
Total current assets	162.4	90.6
Properties, plants and equipment, net	792.5	768.7
Deferred income taxes	—	21.4
Deferred charges and other assets	7.9	4.8
Total assets	$962.8	$885.5
Liabilities and Equity		
Accounts payable	41.5	41.5
Accrued liabilities	3.5	17.0
Interest payable	1.8	—
Payable to affiliate	0.7	—
Total current liabilities	47.5	58.5
Long-term debt	149.7	225.0
Deferred income taxes	1.7	—
Other deferred credits and liabilities	0.3	0.3
Total liabilities	199.2	283.8
Parent Net Equity		
Total equity	763.6	601.7
Total liabilities and parent net equity	$962.8	$885.5

During 2013, the Partnership paid two quarterly cash distributions totaling $23.3 million, of which $9.8 million was paid to public unitholders of the Partnership. On October 22, 2013, the Partnership declared a quarterly cash distribution totaling $13.9 million, of which $5.8 million will be paid to public unitholders of the Partnership. The distribution will be paid on November 29, 2013 to unitholders of record on November 15, 2013.

4. Equity Method Investment

On March 18, 2013, we completed the transaction to form a joint venture, VISA SunCoke, with VISA Steel. VISA SunCoke is comprised of a 440 thousand ton heat recovery cokemaking facility and the facility's associated steam generation units in Odisha, India. We invested $67.7 million to acquire a 49 percent interest in VISA SunCoke with VISA Steel holding the remaining 51 percent interest. This investment is accounted for under the equity method under which investments are initially recorded at cost. We recognize our share of earnings in VISA SunCoke on a one-month lag and began recognizing such earnings in the second quarter of 2013. We intend to permanently reinvest the earnings of VISA SunCoke, and accordingly, no provision for U.S. income taxes has been recorded on such earnings. During the three and nine months ended September 30, 2013, we recognized $2.3 million and $2.5 million of equity losses in VISA SunCoke, respectively.

5. Acquisition

On August 30, 2013, the Partnership completed its acquisition of the assets and business operations of Lakeshore Coal Handling Corporation ("Lakeshore"), now called SunCoke Lake Terminal LLC ("Lake Terminal") for $28.6 million. Prior to the acquisition, the entity that owns SunCoke's Indiana Harbor cokemaking operations was a customer of Lakeshore and held the purchase rights to Lakeshore. Concurrent with the closing of the transaction, the Partnership paid $1.8 million to DTE Energy Company, the third party investor owning a 15 percent interest in the entity that owns Indiana Harbor, in consideration for assigning its share of the Lake Terminal buyout rights to the Partnership. The Partnership recognized this payment in selling, general, and administrative expenses on the Consolidated Statement of Income during the period.

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Located in East Chicago, Indiana, Lake Terminal does not take possession of coal but instead derives its revenue by providing coal handling and blending services to its customers on a per ton basis. Lake Terminal has and will continue to provide coal handling and blending services to SunCoke's Indiana Harbor cokemaking operations. In September 2013, Lake Terminal and Indiana Harbor entered into a new 10 year contract with terms equivalent to those of an arm's-length transaction. The results of Lake Terminal have been included in the Consolidated Financial Statements since the acquisition date, and are included in the new Coal Logistics segment. The Partnership recognized plant, property, and equipment at the fair value of $25.9 million and inventory of $2.7 million in exchange for the $28.6 million of consideration paid. No goodwill was recorded as a result of this acquisition.

Inclusive of intersegment sales, the acquisition of Lake Terminal increased revenues by $1.1 million and operating income by $0.5 million for both the three and nine months ended September 30, 2013. The acquisition of Lake Terminal is not material to the Company's Consolidated Financial Statements. Therefore, pro forma information has not been presented.

6. Income Taxes

Prior to the Distribution Date, SunCoke Energy and certain subsidiaries of Sunoco were included in the consolidated federal and certain consolidated, combined or unitary state income tax returns filed by Sunoco. However, SunCoke Energy's provision for income taxes and the deferred income tax amounts reflected in the Consolidated Financial Statements have been determined on a theoretical separate-return basis through the Distribution Date. Prior to the Separation Date, any current federal and state income tax amounts were settled with Sunoco under a previous tax sharing arrangement. Under this previous tax sharing arrangement, net operating losses and tax credit carryforwards generated on a theoretical separate-return basis could be used to offset future taxable income determined on a similar basis. Such benefits were reflected in the Company's deferred tax assets, notwithstanding the fact that such net operating losses and tax credits may actually have been realized on Sunoco's consolidated income tax returns, or may be realized in future consolidated income tax returns covering the period through the Distribution Date.

On the Separation Date, SunCoke Energy and Sunoco entered into a new tax sharing agreement that governs the parties' respective rights, responsibilities and obligations with respect to tax liabilities and benefits, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings and other matters regarding taxes. In general, under the tax sharing agreement:

- With respect to any periods ending at or prior to the Distribution, SunCoke Energy is responsible for any U.S. federal income taxes and any U.S. state or local income taxes reportable on a consolidated, combined or unitary return, in each case, as would be applicable to SunCoke Energy as if it filed tax returns on a stand-alone basis. With respect to any periods beginning after the Distribution, SunCoke Energy is responsible for any U.S. federal, state or local income taxes of it or any of its subsidiaries.
- Sunoco is responsible for any income taxes reportable on returns that include only Sunoco and its subsidiaries (excluding SunCoke Energy and its subsidiaries), and SunCoke Energy is responsible for any income taxes filed on returns that include only it and its subsidiaries.
- Sunoco is responsible for any non-income taxes reportable on returns that include only Sunoco and its subsidiaries (excluding SunCoke Energy and its subsidiaries), and SunCoke Energy is responsible for any non-income taxes filed on returns that include only it and its subsidiaries.

SunCoke Energy is generally not entitled to receive payment from Sunoco in respect of any of SunCoke Energy's tax attributes or tax benefits or any reduction of taxes of Sunoco. Moreover, Sunoco is generally entitled to refunds of income taxes with respect to periods ending at or prior to the Distribution. If SunCoke Energy realizes any refund, credit or other reduction in otherwise required tax payments in any period beginning after the Distribution Date as a result of an audit adjustment resulting in taxes for which Sunoco would otherwise be responsible, then, subject to certain exceptions, SunCoke Energy must pay Sunoco the amount of any such taxes for which Sunoco would otherwise be responsible. Further, if any taxes result to Sunoco as a result of a reduction in SunCoke Energy's tax attributes for a period ending at or prior to the Distribution Date pursuant to an audit adjustment (relative to the amount of such tax attribute reflected on Sunoco's tax return as originally filed), then, subject to certain exceptions, SunCoke Energy is generally responsible to pay Sunoco the amount of any such taxes.

SunCoke Energy has also agreed to certain restrictions that are intended to preserve the tax-free status of the contribution and the Distribution. These covenants include restrictions on SunCoke Energy's issuance or sale of stock or other securities (including securities convertible into our stock but excluding certain compensatory arrangements), and sales of assets outside the ordinary course of business and entering into any other corporate transaction which would cause SunCoke Energy to undergo a 50 percent or greater change in its stock ownership.

SunCoke Energy has generally agreed to indemnify Sunoco and its affiliates against any and all tax-related liabilities incurred by them relating to the contribution or the Distribution to the extent caused by an acquisition of SunCoke Energy's

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stock or assets, or other of its actions. This indemnification applies even if Sunoco has permitted SunCoke Energy to take an action that would otherwise have been prohibited under the tax-related covenants as described above.
Under the tax sharing agreement, certain deferred tax assets attributable to net operating losses and tax credit carryforwards, which had been reflected in SunCoke Energy's Consolidated Balance Sheets prior to the Separation Date on a theoretical separate-return basis, were no longer realizable by SunCoke Energy. Accordingly, after the Separation Date, current and deferred tax benefits totaling $229.2 million were eliminated from the Consolidated Balance Sheets, $88.2 million of which were eliminated in the nine months ended September 30, 2012, with a corresponding reduction to SunCoke Energy's equity accounts.

SunCoke Energy's tax provision was computed on a theoretical separate-return basis through the Distribution Date. To the extent any tax assets or liabilities computed on that basis differ from amounts actually payable or realizable under the provisions of the tax sharing agreement, adjustments to the tax assets and liabilities will be reflected as an income tax expense or benefit with a corresponding payable due to Sunoco, if necessary, when such amounts have been effectively settled under the terms of the tax sharing agreement. For the nine months ended September 30, 2013, SunCoke recorded income tax expense of $1.7 million to settle potential obligations under the provisions of the tax sharing agreement. SunCoke Energy will continue to monitor the utilization of all tax attributes subject to the tax sharing agreement as applicable tax returns are filed or as tax examinations progress and will record additional adjustments when necessary, consistent with the terms of the tax sharing agreement.
At the end of each interim period, we make our best estimate of the effective tax rate expected to be applicable for the full fiscal year and the impact of discrete items, if any, and adjust the rate as necessary.
The Company's income tax provision for the three and nine months ended September 30, 2013 is lower than the U.S. federal statutory income tax rate primarily due to the impact of earnings that are attributable to noncontrolling ownership interests in partnerships and nonconventional fuel tax credits. The income tax provision for the nine months ended September 30, 2013 includes $0.4 million related to prior period adjustments associated with local income taxes due for the Company's Middletown operations, a $1.7 million favorable provision-to-return adjustment as a result of filing our 2012 federal income tax returns, $1.4 million of additional valuation allowances associated with state and local taxes and $1.7 million to settle potential obligations under the provisions of our tax sharing agreement with Sunoco. The Company's income tax provision for the three and nine months ended September 30, 2012 is lower than the U.S. federal statutory income tax rate principally due to the impact of nonconventional fuel tax credits.
We have not provided U.S. income taxes on our share of earnings from our joint venture with VISA Steel as we intend to permanently reinvest the earnings of VISA SunCoke.

7. Inventories

The Company's inventory consists of metallurgical coal, which is the principal raw material for the Company's cokemaking operations, coke, which is the finished good sold by the Company to its customers, and materials, supplies and other.
These components of inventories were as follows:

	September 30, 2013	December 31, 2012
	(Dollars in millions)	
Coal	$90.5	$108.0
Coke	8.2	11.8
Materials, supplies and other	35.8	32.0
Consigned coke inventory [(1)]	—	8.3
	$134.5	$160.1

(1) During 2011, we estimated that Indiana Harbor would fall short of its 2011 annual minimum coke production requirements by approximately 122 thousand tons. Accordingly, we entered into contracts to procure approximately 133 thousand tons of coke from third parties. The Company then entered into an agreement to sell approximately 95 thousand tons of this purchased coke to a customer on a consignment basis. During 2012, the customer consumed 73 thousand tons of consigned coke and the remaining 22 thousand tons of consigned coke

were consumed during the first quarter of 2013.

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8. Retirement Benefits Plans

Defined Benefit Pension Plan and Postretirement Health Care and Life Insurance Plans

The Company has a noncontributory defined benefit pension plan ("defined benefit plan"), which provides retirement benefits for certain of its employees. The Company also has plans which provide health care and life insurance benefits for many of its retirees ("postretirement benefit plans"). The postretirement benefit plans are unfunded and the costs are borne by the Company.

Effective January 1, 2011, pension benefits under the Company's defined benefit plan were frozen for all participants in this plan. The Company also amended its postretirement benefit plans during the first quarter of 2010. Postretirement medical benefits for future retirees were phased out or eliminated, effective January 1, 2011, for non-mining employees with less than ten years of service and employer costs for all those still eligible for such benefits were capped. As a result of these changes, the Company's postretirement benefit liability declined $36.7 million during 2010. Most of the benefit of this liability reduction is being amortized into income through 2016.

Defined benefit plan expense consisted of the following components:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in millions)			
Interest cost on benefit obligations	0.3	0.4	1.0	1.1
Expected return on plan assets	(0.6)	(0.5)	(1.8)	(1.4)
Amortization of actuarial losses	0.3	0.2	0.8	0.7
	$—	$0.1	$—	$0.4

Postretirement benefit plans benefit consisted of the following components:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in millions)			
Service cost	$0.1	$0.1	$0.2	$0.2
Interest cost on benefit obligations	0.3	0.4	1.0	1.4
Amortization of:				
Actuarial losses	0.4	0.4	1.1	1.1
Prior service benefit	(1.4)	(1.4)	(4.3)	(4.2)
	$(0.6)	$(0.5)	$(2.0)	$(1.5)

9. Accrued Liabilities

Accrued liabilities consisted of the following:

	September 30, 2013	December 31, 2012
	(Dollars in millions)	
Accrued sales discounts[1]	$12.5	$36.2
Accrued benefits	18.3	21.5
Other taxes payable	11.8	10.9
Other	18.3	22.6
Total	$60.9	$91.2

(1) At December 31, 2012, we had $12.4 million accrued related to sales discounts to be paid to our customer at our Haverhill facility. During the first quarter of 2013, we settled this obligation for $11.8 million which resulted in a gain of $0.6 million. This gain is recorded in sales and other operating revenue on our Consolidated Statement of Income.

10. Debt

Total debt, including the current portion of long-term debt, consisted of the following:

	September 30, 2013	December 31, 2012
	(Dollars in millions)	
Term loans, bearing interest at variable rates, due 2018, net of original issue discount of $1.0 million and $1.7 million at September 30, 2013 and December 31, 2012, respectively(1)	$99.1	$323.4
7.625% senior notes, due 2019 ("Senior Notes")	400.0	400.0
7.375% senior notes, due 2020 ("Partnership Notes")	150.0	—
Total debt	$649.1	$723.4
Less: current portion of long-term debt	0.8	3.3
Total long-term debt	$648.3	$720.1

(1) Borrowed under the Company's Credit Agreement on July 26, 2011, as amended ("Credit Agreement").

Concurrent with the IPO, SunCoke Energy entered into a Credit Agreement that provides for a seven-year term loan ("Term Loan") in a principal amount of $300.0 million. The Credit Agreement provides for up to $75.0 million in uncommitted incremental facility term loans ("Incremental Facilities") that are available subject to the satisfaction of certain conditions. SunCoke Energy also issued $400.0 million aggregate principal amount of senior notes ("Senior Notes") that bear interest at a rate of 7.625 percent per annum and will mature in 2019 with all principal paid at maturity.

As of September 30, 2013, there was $45.0 million of capacity under the Incremental Facilities. The Credit Agreement also provides for a $150.0 million revolving facility ("Revolving Facility") that can be used to finance capital expenditures, acquisitions, working capital needs and for other general corporate purposes. As of September 30, 2013, the Revolving Facility had letters of credit outstanding of $2.1 million, leaving $147.9 million available subject to the terms of the Credit Agreement.

In connection with the closing of the Partnership offering, the Partnership repaid $225.0 million of our Term Loan and we entered into an amendment to our Credit Agreement. In conjunction with the repayment, we incurred a charge of approximately $2.9 million, which is included in interest expense, net on the Consolidated Statement of Income, representing the write-off of unamortized debt issuance costs and original issue discount related to the portion of the Term Loan extinguished.

The amendment to our Credit Agreement, among other things, modified provisions to reflect the Partnership offering including (i) changing the definition of "Consolidated Net Income" to include cash distributions received by the Company or a Restricted Subsidiary from an Unrestricted Subsidiary that is controlled directly or indirectly by the Company when calculating "Consolidated Net Income", (ii) clarifying that obligations incurred by certain subsidiaries of the Company at or about the timing of the closing of the Partnership offering shall not be included in the definition of "Indebtedness," and (iii) permitting an allowance for investments in Middletown Coke Company, LLC and Haverhill Coke Company LLC and certain other subsidiaries of the Company. In addition, we also designated Middletown Coke Company, LLC and Haverhill Coke Company LLC as unrestricted subsidiaries. Furthermore, the term of the Credit Agreement was extended to January 2018. We incurred debt issuance costs of $0.7 million in conjunction with this amendment which will be amortized through January 2018.

In addition, with the closing of the Partnership offering, the Partnership issued $150.0 million of Partnership Notes. The Partnership Notes have an interest rate of 7.375 percent and mature on February 1, 2020. The Partnership may redeem some or all of the Partnership Notes prior to February 1, 2016 by paying a "make-whole" premium. The Partnership also may redeem some or all of the Partnership Notes on or after February 1, 2016 at specified redemption prices. In addition, prior to February 1, 2016, the Partnership may redeem up to 35 percent of the Partnership Notes using the proceeds of certain equity offerings. If the Partnership sells certain of its assets or experiences specific kinds of changes in control, subject to certain exceptions, the Partnership must offer to purchase the Partnership Notes. In conjunction with the closing of the Partnership offering, the Partnership also entered into a $100.0 million revolving credit facility with a term extending through January 2018. In conjunction with these transactions, the Partnership incurred debt issuance costs of $5.9 million, $0.8 million of which were immediately expensed and are included in interest expense, net on the Consolidated Statement of Income, as they were related to the portion of the issuance that was considered a modification of the existing Term Loan discussed above. Approximately $0.6 million of these costs were paid in 2012. This credit facility was amended on August 28, 2013, increasing the total aggregate commitments from lenders to $150.0 million and now also providing for up to $100.0 million uncommitted incremental revolving capacity, subject to the satisfaction of certain conditions. We paid $0.9 million in fees related to the credit facility amendment. The fees have been included in deferred charges and other assets in the Consolidated Balance Sheet, which will be amortized over the life of the facility. As of September 30, 2013, this credit facility had letters of credit outstanding of $0.7 million, leaving $149.3 million available.

11. Commitments and Contingent Liabilities

The Company is subject to indemnity agreements with current and former third-party investors of Indiana Harbor and Jewell related to certain tax benefits that they earned as limited partners. Based on the applicable statute of limitations, as well as published filings of the limited partners, the Company believes that tax audits for years 2006 and 2007, relating to tax credits of approximately $51 million, may still be open for the limited partners and subject to examination. As of September 30, 2013, the Company has not been notified by the limited partners that any items subject to the indemnification are under examination and further believes that the potential for any claims under the indemnity agreements is remote.

SunCoke is also party to an omnibus agreement pursuant to which we will provide remarketing efforts to the Partnership upon the occurrence of certain potential adverse events under our coke sales agreements, indemnification of certain environmental costs and preferential rights for growth opportunities.

In June 2013, AK Steel experienced a blast furnace outage at their Middletown plant. Due to this outage, we agreed to manage production at our Haverhill cokemaking facility to be consistent with annual contract maximums and to temporarily scale back coke production at our Middletown facility to name plate capacity levels in the second half of 2013. Pursuant to the omnibus agreement, the Company remitted a make-whole payment to the Partnership of $0.6 million in the third quarter 2013, which was based on lower production levels at our Middletown cokemaking facility. We recorded this payment as a capital contribution to the Partnership. The Company expects to make additional payments of approximately $0.4 million in the fourth quarter 2013 due to the anticipated lower coke production levels at the Middletown facility. In addition, the Partnership plans to provide AK Steel extended payment terms on December 2013 coke production and pursuant to our omnibus agreement, the Company will remit to the Partnership the amounts due under normal contract terms and hold the extended-term receivables with AK Steel, resulting in a shift of approximately $20 million in expected operating cash flow from 2013 to early 2014.

The United States Environmental Protection Agency (the “EPA”) has issued Notices of Violations (“NOVs”) for our Haverhill and Granite City cokemaking facilities which stem from alleged violations of our air emission operating permits for these facilities. We are working in a cooperative manner with the EPA, the Ohio Environmental Protection Agency and the Illinois Environmental Protection Agency to address the allegations, and a Consent Decree among the parties was lodged in federal court in June 2013. The settlement includes payment of a civil penalty, and we estimate our reasonably probable loss to be approximately $2.2 million. Further, the settlement consists of capital projects to improve reliability of the energy recovery systems and enhance environmental performance at the Haverhill and Granite City facilities. As a result of discussions with the EPA, we spent approximately $5 million related to these projects in 2012 and expect to spend approximately $23 million in 2013. We also plan to spend an additional $72 million in the 2014 to 2016 time frame. A portion of the proceeds from the Partnership offering is being used to fund $67 million of the total spending on this project.

The Company has received NOVs from the EPA related to our Indiana Harbor cokemaking facility. The Company is working in a cooperative manner to address the allegations with the EPA, the Indiana Department of Environmental Management ("IDEM") and Cokenergy, Inc., an independent power producer that owns and operates an energy facility, including heat recovery equipment, a flue gas desulfurization system and a power generation plant that processes hot flue gas from our Indiana Harbor cokemaking facility to produce steam and electricity and to reduce the sulfur and particulate content of such flue gas. Settlement may require payment of a penalty for alleged past violations as well as undertaking capital projects to enhance environmental performance. In conjunction with the contract renewal with our customer, we are undertaking an estimated $85 million refurbishment project to improve the reliability and condition of the facility. We spent $14 million related to this project in 2012 and anticipate spending

$58 million in 2013. We believe that the scope of the project will address items that may be required in connection with the settlement of the NOVs at our Indiana Harbor cokemaking facility. At this time, the Company cannot yet assess any future injunctive relief or potential monetary penalty and any potential future citations. The Company is unable to estimate a range of probable or reasonably possible loss.

The Southwest Ohio Air Quality Agency ("SWOAQA") also issued a NOV to our Middletown facility in November 2012. We responded to the NOV by providing a carbon injection plan requested by SWOAQA. At present, the Company cannot assess whether there will be a monetary penalty or any future citations, but we do not expect such a penalty or citations to be material to the financial position, results of operations or cash flows of the Company at September 30, 2013.

Other legal and administrative proceedings are pending or may be brought against the Company arising out of its current and past operations, including matters related to commercial and tax disputes, product liability, antitrust, employment claims, premises-liability claims, allegations of exposures of third parties to toxic substances and general environmental claims.

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Although the ultimate outcome of these claims cannot be ascertained at this time, it is reasonably possible that some portion of these claims could be resolved unfavorably to the Company. Management of the Company believes that any liability which may arise from such matters would not be material in relation to the financial position, results of operations or cash flows of the Company at September 30, 2013.

12. Restructuring

During the first quarter of 2013, we implemented a reduction in force at our Coal Mining segment. This reduction in force resulted in the termination of 52 employees eligible to receive certain payments. The Company incurred restructuring charges of $0.9 million related to this reduction in force during the first quarter of 2013 and does not anticipate any further significant charges. At September 30, 2013, there was no liability remaining related to the restructuring.

13. Share-Based Compensation

During the nine months ended September 30, 2013, we granted share-based compensation to eligible participants under the SunCoke Energy, Inc. Long-Term Performance Enhancement Plan (“SunCoke LTPEP”).

Stock Options

We granted stock options to purchase 446,948 shares of common stock during the nine months ended September 30, 2013 with an exercise price equal to the closing price of our common stock on the date of grant. The stock options become exercisable in three equal annual installments beginning one year from the date of grant. The stock options expire 10 years from the date of grant. All awards vest immediately upon a change in control and a qualifying termination of employment as defined by the SunCoke LTPEP.

The Company calculates the value of each employee stock option, estimated on the date of grant, using the Black-Scholes option pricing model. The fair value of employee stock options granted during the nine months ended September 30, 2013 was $6.00 using the following weighted-average assumptions:

	Nine months ended September 30, 2013	
Risk free interest rate	0.93	%
Expected term	5 years	
Volatility	44	%
Dividend yield	—	%
Weighted-average exercise price	$16.55	

The Company uses the average implied volatility of the Dow Jones U.S. Steel index coupled with the implied volatility of the S&P 600. Since the Company does not have a direct peer group and only has a limited trading history it believes this approach provides a reasonable implied volatility.

The risk-free interest rate assumption is based on the U.S. Treasury yield curve at the date of grant for periods which approximate the expected life of the option. The dividend yield assumption is based on the Company’s future expectation of dividend payouts. The expected life of employee options represents the average contractual term adjusted by the average vesting period of each option tranche. The Company estimated a three percent forfeiture rate for these awards. This estimated forfeiture rate may be revised in subsequent periods if the actual forfeiture rate differs.

As of September 30, 2013, the Company had 2.3 million stock options outstanding excluding the stock options issued in conjunction with the award modifications discussed below. The Company recognized compensation cost of $1.2 million and $3.3 million for the three and nine months ended September 30, 2013, respectively, and compensation expense of $1.0 million and $2.9 million for the three and nine months ended September 30, 2012. As of September 30, 2013, there was $6.1 million of total unrecognized compensation cost related to these nonvested stock options. This compensation cost is expected to be recognized over the next 1.6 years.

Restricted Stock Units

The Company issued 277,918 restricted stock units (“RSU”) for shares of the Company’s common stock during the nine months ended September 30, 2013 that vest in three annual installments beginning one year from the grant date. The weighted-average fair value of the RSUs granted during the nine months ended September 30, 2013 of $16.54 was based on the closing

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price of our common stock on the date of grant. The Company estimated a three percent forfeiture rate for these awards. This estimated forfeiture rate may be revised in subsequent periods if the actual forfeiture rate differs. All awards vest immediately upon a change in control and a qualifying termination of employment as defined by the SunCoke LTPEP.

As of September 30, 2013, the Company had 489,951 RSUs outstanding excluding the RSUs issued in conjunction with the award modifications discussed below. The Company recognized $0.7 million and $1.7 million in compensation expense during the three and nine months ended September 30, 2013, respectively, and $0.3 million and $1.2 million of compensation expense during the three and nine months ended September 30, 2012, respectively. As of September 30, 2013, there was $6.1 million of total unrecognized compensation cost related to these nonvested RSUs. This compensation cost is expected to be recognized over the next 2.2 years.

Performance Share Units

The Company issued 96,073 performance share units ("PSU") for shares of the Company's common stock during the nine months ended September 30, 2013 that vest on December 31, 2015. All awards vest immediately upon a change in control and a qualifying termination of employment as defined by the SunCoke LTPEP. The weighted average fair value of the PSUs granted during the nine months ended September 30, 2013 is $19.56 and is based on the closing price of our common stock on the date of grant as well as a Monte Carlo simulation for the portion of the award subject to a market condition. The Company estimated a three percent forfeiture rate for these awards. This estimated forfeiture rate may be revised in subsequent periods if the actual forfeiture rate differs.

The number of PSUs ultimately awarded will be adjusted based upon the following metrics: (1) 50 percent of the award will be determined by the Company's three year total shareholder return ("TSR") as compared to the TSR of the companies making up the S&P 600; and (2) 50 percent of the award will be determined by the Company's three year average pre-tax return on capital for the Company's coke business. Each portion of the award may be adjusted between zero and 200 percent of the original units granted.

As of September 30, 2013, the Company had 96,073 PSUs outstanding. The Company recognized $0.2 million and $0.4 million of compensation expense during the three and nine months ended September 30, 2013, respectively. As of September 30, 2013, there was $1.5 million of total unrecognized compensation cost related to these nonvested PSUs. This compensation cost is expected to be recognized over the next 2.4 years.

Award Modifications

Tax equivalent net interest income / spread

$108,590 $81,650 33.0% 3.40% 3.16% 24 $393,077 $275,927 42.5%

Tax equivalent interest rate margin

3.67% 3.42% 25

B NORMAL SPREAD

Interest-earning assets:

Investments:

Investment securities

$126,273 $87,069 45.0% 5.40% 5.00% 40 $4,680,539 $3,483,777 34.4%

Investment management fees

(290) -100.0% 0.00% -0.02% 2

Total investment securities

126,273 86,779 45.5% 5.40% 4.98% 42 4,680,539 3,483,777 34.4%

Trading securities

9 14 -35.7% 3.99% 4.28% (29) 451 654 -31.0%

Money market investments

1,467 1,344 9.2% 4.31% 5.76% (145) 68,060 46,682 45.8%

127,749 88,137 44.9% 5.38% 4.99% 39 4,749,050 3,531,113 34.5%

Loans:

Mortgage
32,932 33,215 -0.9% 6.46% 6.77% (31) 1,019,699 981,416 3.9%

Commercial
5,251 9,156 -42.6% 8.24% 7.90% 34 127,401 231,915 -45.1%

Consumer
1,327 1,792 -25.9% 10.30% 10.81% (51) 25,778 33,168 -22.3%

39,510 44,163 -10.5% 6.74% 7.09% (35) 1,172,878 1,246,499 -5.9%

167,259 132,300 26.4% 5.65% 5.54% 11 5,921,928 4,777,612 24.0%

Interest-bearing liabilities:

Deposits:

Non-interest bearing deposits
36,513 36,266 0.7%

Now accounts
398 409 -2.6% 1.27% 1.16% 11 62,977 70,282 -10.4%

Savings
7,701 6,268 22.9% 3.66% 4.18% (52) 420,841 299,900 40.3%

Certificates of deposit
16,595 19,172 -13.4% 4.29% 4.56% (27) 773,648 840,369 -7.9%

24,694 25,849 -4.5% 3.82% 4.15% (33) 1,293,979 1,246,817 3.8%

Borrowings:

Repurchase agreements
80,448 69,636 15.5% 4.20% 4.60% (40) 3,828,410 3,025,163 26.6%

Interest rate risk management
(773) -100.0% 0.00% -0.05% 5

Financing fees
441 -100.0% 0.00% 0.03% (3)

Total repurchase agreements
80,448 69,304 16.1% 4.20% 4.58% (38) **3,828,410 3,025,163 26.6%**

FHLB advances
7,046 3,905 80.4% 4.24% 4.60% (36) 332,402 169,725 95.8%

Subordinated capital notes
1,236 1,524 -18.9% 6.85% 8.58% (173) 36,083 35,539 1.5%

Term notes
195 -100.0% 0.00% 5.12% (512) 7,044 -100.0%

Other borrowings
491 445 10.3% 2.58% 5.29% (271) 37,977 17,397 118.3%

89,221 75,373 18.4% 4.21% 4.63% (42) 4,234,872 3,254,868 30.1%

113,915 101,222 12.5% 4.12% 4.50% (38) 5,528,851 4,501,685 22.8%

Net interest income / spread

$53,344 $31,078 71.6% 1.53% 1.04% 49

Interest rate margin

1.80% 1.30% 50

Excess of average interest-earning assets over average interest-bearing liabilities

$393,077 $275,927 42.5%

Average interest-earning assets over average interest-bearing liabilities ratio

107.11% 106.13%

C. Changes in net interest income due to:	**Volume**	**Rate**	**Total**
Interest Income:			
Investments	$30,400	$ 9,213	$39,613
Loans	(2,609)	(2,045)	(4,654)
	27,791	**7,168**	**34,959**
Interest Expense:			
Deposits	978	(2,133)	(1,155)
Repurchase agreements	18,402	(7,258)	11,144
Other borrowings	4,670	(1,966)	2,704
	24,050	**(11,357)**	**12,693**
Net Interest Income	**$ 3,741**	**$ 18,525**	**$22,266**

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

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For the quarter and six-month period ended June 30, 2008, net interest income amounted to $28.4 million and $53.3 million, respectively, an increase of 60.7% and 71.6% from $17.7 million and $31.1 million, in the same periods of the previous year. The increase for the quarter and six-month period reflects a 20.3% and 26.4% increase in interest income, due to a positive volume variance $11.8 million and $27.8 million, respectively, and a positive rate variance of $2.6 million and $7.2 million, respectively. The increase of 6.8% and 12.5% in interest expense for the quarter and six-month period ended June 30, 2008, was primarily the result of an increase of $10.1 million and $24.1 million, respectively in interest expense from higher volume of interest-bearing liabilities, offset by reduced rates on such interest-bearing liabilities. Interest rate spread increased 51 basis points to 1.68% for the quarter ended June 30, 2008, from 1.17% in the June 30, 2007 quarter, and 49 basis points to 1.53% for the six-month period ended June 30, 2008 from 1.04% for the year ago period. These increases reflect the full benefits of the actions taken by the Group to reposition the available-for-sale investment securities portfolio and its funding in late 2006 and during 2007.
For the quarter and six-month period ended June 30, 2008, the average balances of total interest-earnings assets were $5.985 billion and $5.922 billion, an 18.6% and 24.0% increase from the same periods last year. The increase in the quarterly average balance reflects increases of 26.0% to $4.777 billion in the investment portfolio, partially offset by a decrease of 3.9% to $1.208 billion in the loans portfolio for the 2008 quarter. The increase in the six-month period average balance reflects increases of 34.5% to $4.749 billion in the investment portfolio, partially offset by a decrease of 5.9% to $1.173 billion in the loans portfolio for the 2008 six-month period.
For the quarter and six-month period ended June 30, 2008, the average yield on interest-earning assets was 5.69% and 5.65%, respectively, compared to 5.61% and 5.54% in the same period last year, due to higher average yields in the investment portfolio, offset by lower yields in the loan portfolio. The investment portfolio yield increased to 5.48% and 5.38% in the quarter and six-month period ended June 30, 2008, respectively, versus 5.12% and 4.99%, in the same period last year, respectively, due to additions of higher-yielding investments.
For the quarter and six-month period ended June 30, 2008, interest expense amounted to $56.7 million and $113.9 million, respectively, an increase of 6.8% and 12.5%, respectively, from $53.1 million and $101.2 million, in the same period last year, mainly resulting from higher volume of interest-bearing liabilities.
For the quarter ended June 30, 2008, the cost of deposits decreased 81 basis points to 3.44%, as compared to the same period a year ago. For the six-month period ended June 30, 2008, the cost of deposits decreased 33 basis points to 3.82%, as compared to the same period a year ago. The decrease reflects lower average rates paid on higher balances, most significantly in savings and certificates of deposit accounts. For the quarter and six-month period ended June 30, 2008, the cost of borrowings decreased 31 basis points and 42 basis points, respectively, to 4.20% and 4.21%, respectively, from the same period last year.

TABLE 2 NON-INTEREST INCOME SUMMARY:
FOR THE QUARTERS AND SIX-MONTHS PERIODS ENDED JUNE 30, 2008 AND 2007
(In thousands)

	Quarter ended June 30,			Six-Month period ended June 30,		
	2008	2007	Variance %	2008	2007	Variance %
Financial service revenues	$ 4,500	$ 4,049	11.1%	$ 8,740	$ 8,892	-1.7%
Banking service revenues	1,395	2,265	-38.4%	2,922	4,139	-29.4%
Investment banking revenues	12		100.0%	750		100.0%
Mortgage banking activities	545	170	220.6%	1,551	232	568.5%
Total banking and financial service revenues	6,452	6,484	-0.5%	13,963	13,263	5.3%

Securities net activity	198	10	1880.0%	9,512	369	2477.8%
Derivatives net gain (loss)	228	88	159.1%	(7,575)	8,384	-190.4%
Trading net gain (loss)	16	2	700.0%	(1)	2	-150.0%
Income from other investments	16	192	-91.7%	126	701	-82.0%
Securities, derivatives and trading activities	458	292	56.8%	2,062	9,456	-78.2%
Equity in earnings of investment in limited liability partnership		967	100.0%		76	100.0%
Gain (loss) on foreclosed real estate	(260)	30	-966.7%	(510)	67	-861.2%
Other		23	100.0%	(1)	65	-101.5%
Total non-interest income	**$ 6,650**	**$ 7,796**	**-14.7%**	**$ 15,514**	**$ 22,927**	**-32.3%**

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

Non-interest income totaled $6.7 million and $15.5 million in the quarter and six-month periods ended June 30, 2008, a decrease of 14.7% and 32.3% when compared to $7.8 million and $22.9 million in the same periods last year. Decreases in revenues from securities and derivatives activities were partially offset by increases in revenues generated mortgage and investment banking activities.

Financial service revenues, generated from trust, mortgage banking, investment banking, brokerage, and insurance activities is the principal recurring component of non-interest income. For the quarter and six-month periods ended June 30, 2008, revenues from such activities were $6.5 million and $14.0 million, an decrease of 0.5% when compared with the quarter last year and an increase of 5.3% compared with June 2007, from the $6.5 million and $13.3 million recorded by the Group for the same respective period last year. Financial service revenues increased by 11.1% to $4.5 million for the quarter and decreased by 1.7% to $8.7 million for the six-month periods ended June 30, 2008, from $4.0 million and $8.9 million in the same corresponding period last year. Revenues from mortgage banking activities for the quarter and six-month periods ended June 30, 2008, were $545,000 and $1.6 million, a considerable increase when compared to $170,000 and $232,000 for the same period a year ago. Investment banking revenues for the quarter and six-month periods ended June 30, 2008, amounted to $12,000 and $750,000.

Banking service revenue, another major component of non-interest income, consists primarily of fees generated by deposit accounts, electronic banking services, and bank service commissions. For the quarter and six-month periods ended June 30, 2008, these revenues were $1.4 million and $2.9 million, a decrease of 38.4% and 29.4% from $2.3 million and $4.1 million for the same period last year, reflecting reduced consumer banking activity.

For the quarter and six-month periods ended June 30, 2008, gains from securities, derivatives and trading activities were $458,000 and $2.1 million, compared to $292,000 and $9.5 million for the same period last year. During the six-month period ended June 30, 2008, losses of $7.6 million were recognized and reflected as Derivatives in the unaudited consolidated statements of income. This was mainly due to an interest-rate swap contract that the Group entered in on January 2008 to manage the Group s interest rate risk exposure with a notional amount of $500 million. Such contract was subsequently terminated, resulting in a loss to the Group of approximately $7.9 million. For the six-month period ended June 30, 2007, gains of $8.4 million were recognized and reflected as Derivatives in the unaudited consolidated statements of income, which included and $8.2 million gain from the elimination of forecasted transactions on interest rate swaps unwound in 2006.

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TABLE 3 NON-INTEREST EXPENSES SUMMARY
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2008 AND 2007
(In thousands)

	Quarter Ended June 30,			Six-Month Period Ended June 30,		
	2008	2007	Variance %	2008	2007	Variance %
Compensation and employee benefits	$ 7,824	$ 6,916	13.1%	$ 15,539	$ 13,661	13.7%
Occupancy and equipment	3,365	3,343	0.7%	6,652	6,337	5.0%
Professional and service fees	2,267	1,984	14.3%	4,147	3,522	17.7%
Advertising and business promotion	836	1,118	-25.2%	1,910	1,911	-0.1%
Loan servicing expenses	339	540	-37.2%	670	1,063	-37.0%
Directors and investor relations expenses	303	769	-60.6%	581	1,300	-55.3%
Taxes, other than payroll and income taxes	607	489	24.1%	1,218	937	30.0%
Electronic banking charges	396	457	-13.3%	814	916	-11.1%
Clearing and wrap fees expenses	313	310	1.0%	607	675	-10.1%
Communications	325	308	5.5%	650	646	0.6%
Insurance	579	211	174.4%	1,181	427	176.6%
Foreclosure expenses	201	338	-40.5%	351	405	-13.3%
Printing, postage, stationery and supplies	245	189	29.6%	522	391	33.5%
Other expenses	480	505	-5.0%	968	1,113	-13.0%
Total non-interest expenses	**$ 18,080**	**$ 17,477**	**3.5%**	**$ 35,810**	**$ 33,304**	**7.5%**
Relevant ratios and data:						
Compensation and benefits to non-interest expenses	**43.3%**	**39.6%**		**43.4%**	**41.0%**	
Compensation to total assets (annualized)	**0.52%**	**0.52%**		**0.51%**	**0.52%**	
Average compensation per employee (annualized)	**$ 56.6**	**$ 53.6**		**$ 56.5**	**$ 52.1**	
Average number of employees	**553**	**516**		**550**	**524**	
Assets owned per average employee	**$ 10,959**	**$ 10,253**		**$ 11,019**	**$ 10,097**	

Non-interest expenses for the quarter and six-month period ended June 30, 2008, were $18.1 million and $35.8 million, representing increases of 3.5% and 7.5%, respectively, when compared to $17.5 million and $33.3 million in the same period a year ago, primarily as a result of higher professional fees, insurance expense and compensation expense. The non-interest expense results reflect an efficiency ratio of 51.82% for the quarter ended June 30, 2008, compared to 72.30% in the same quarter last year. For the six-month period ended June 30, 2007, the efficiency ratio was 53.20% compared to 75.11% for the same period last year. The efficiency ratio measures how much of a company s revenue is used to pay operating expenses. The Group computes its efficiency ratio by dividing non-interest expenses by the sum of its net interest income and non-interest income, but excluding gains on sale of investments securities, derivatives gains or losses and other income that may be considered volatile in nature. Management believes that the exclusion of those items permit greater comparability. Amounts presented as part of non-interest income that are excluded from the efficiency ratio computation amounted to $1.6 million and $9.7 million for the six-month period ended June 30, 2008 and 2007, respectively.

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TABLE 4 ALLOWANCE FOR LOAN LOSSES SUMMARY
FOR THE QUARTERS AND SIX-MONTH PERIODS ENDED JUNE 30, 2008 AND 2007
(In thousands)

	Quarter Ended June 30, 2008	Quarter Ended June 30, 2007	Change in %	Six-Month Period Ended June 30, 2008	Six-Month Period Ended June 30, 2007	Change in %
Balance at beginning of period	$ 11,092	$ 8,046	37.9%	$ 10,161	$ 8,016	26.8%
Provision for loan losses	1,980	1,375	44.0%	3,630	2,450	48.2%
Net credit losses see Table 5	(1,187)	(989)	20.0%	(1,906)	(2,034)	-6.3%
Balance at end of period	**$ 11,885**	**$ 8,432**	**41.0%**	**$ 11,885**	**$ 8,432**	**41.0%**
Selected Data and Ratios:						
Outstanding gross loans at June 30,				$ 1,230,042	$ 1,280,609	-3.9%
Allowance coverage ratios:						
Total loans				0.97%	0.65%	49.23%
Non-performing loans				17.27%	16.70%	3.41%
Non-mortgage non-performing loans				299.67%	217.30%	37.91%

TABLE 5 NET CREDIT LOSSES STATISTICS
(In thousands)

	Quarter Ended June 30, 2008	Quarter Ended June 30, 2007	Change in %	Six-Month Period Ended June 30, 2008	Six-Month Period Ended June 30, 2007	Change in %
Mortgage						
Charge-offs	$ (314)	$ (480)	-34.6%	$ (480)	$ (1,026)	-53.2%
Recoveries						
	(314)	**(480)**	**-34.6%**	**(480)**	**(1,026)**	**-53.2%**
Commercial						
Charge-offs	(142)	(14)	914.3%	(142)	(14)	914.3%
Recoveries	1	13	-92.3%	14	22	-36.4%
	(141)	**(1)**	**14000.0%**	**(128)**	**8**	**-1700.0%**
Consumer						
Charge-offs	(801)	(611)	31.1%	(1,432)	(1,232)	16.2%
Recoveries	69	103	-33.0%	134	216	-38.0%
	(732)	**(508)**	**44.1%**	**(1,298)**	**(1,016)**	**27.8%**
Net credit losses						
Total charge-offs	(1,257)	(1,105)	13.8%	(2,054)	(2,272)	-9.6%
Total recoveries	70	116	-39.7%	148	238	-37.8%

	$	**(1,187)**	**$**	**(989)**	**20.0%**	**$**	**(1,906)**	**$**	**(2,034)**	**-6.3%**
Net credit losses (recoveries) to average loans outstanding (1):										
Mortgage		0.12%		0.19%			0.09%		0.21%	
Commercial		0.36%		0.00%			0.20%		-0.01%	
Consumer		11.25%		6.37%			10.07%		6.13%	
Total		**0.39%**		**0.31%**			**0.33%**		**0.33%**	
Recoveries to charge-offs		**5.57%**		**10.50%**	-47.0%		**7.21%**		**10.48%**	-31.2%
Average loans:										
Mortgage	$	1,026,184	$	995,669	3.1%	$	1,019,699	$	981,416	3.9%
Commercial		155,889		229,750	-32.1%		127,401		231,915	-45.1%
Consumer		26,025		31,889	-18.4%		25,778		33,168	-22.3%
Total	**$**	**1,208,098**	**$**	**1,257,308**	**-3.9%**	**$**	**1,172,878**	**$**	**1,246,499**	**-5.9%**

(1) Annualized ratios

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TABLE 6 ALLOWANCE FOR LOSSES BREAKDOWN
AS OF JUNE 30, 2008 AND 2007, AND DECEMBER 31, 2007
(In thousands)

	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Allowance for loan losses breakdown:				
Mortgage	$ 6,618	$ 5,958	11.1%	$ 4,476
Commercial	2,618	1,838	42.4%	1,953
Consumer	1,967	2,006	-1.9%	1,711
Unallocated allowance	682	359	90.0%	292
	$ 11,885	**$ 10,161**	**17.0%**	**$ 8,432**
Allowance composition:				
Mortgage	55.7%	58.7%		53.1%
Commercial	22.0%	18.1%		23.2%
Consumer	16.6%	19.7%		20.3%
Unallocated allowance	5.7%	3.5%		3.5%
	100.0%	**100.0%**		**100.0%**

The provision for loan losses for the quarter and six-month periods ended June 30, 2008, totaled $1.9 million and $3.6 million, representing an increase of 44.0% and 48.2% from the $1.4 million and $2.5 million reported for the same quarter last year. Based on an analysis of the credit quality and composition of the loan portfolio, the Group determined that the provision for the quarter and six-month period ended June 30, 2008, was adequate in order to maintain the allowance for loan losses at an appropriate level.

Net credit losses for the quarter and six-month periods ended June 30, 2008, increased from $1.0 million (0.31% of average loans outstanding) in the quarter ended June 30, 2007, to $1.2 million (0.39%) in the corresponding quarter of 2008, and decreased from $2.0 million (0.33% average loans outstanding) in the first six months of 2007, to $1.9 million (0.33%) for the same period of 2008. The decrease was primarily due to a $546,000 reduction in net credit losses from mortgage loans. Non-performing loans of $68.8 million at June 30, 2008, were 36.3% higher than the $50.5 million at June 30, 2007, but only 4.1% higher than the $66.1 million at December 31, 2007, and 0.5% lower than the $69.2 million at March 31, 2008, the first sequential quarter reduction in non-performing loans in two years.

The Group maintains an allowance for loan losses at a level that management considers adequate to provide for probable losses based upon an evaluation of known and inherent risks. The Group s allowance for loan losses policy provides for a detailed quarterly analysis of probable losses.

The Group follows a systematic methodology to establish and evaluate the adequacy of the allowance for loan losses to provide for inherent losses in the loan portfolio. This methodology includes the consideration of factors such as economic conditions, portfolio risk characteristics, prior loss experience, and results of periodic credit reviews of individual loans. The provision for loan losses charged to current operations is based on such methodology. Loan losses are charged and recoveries are credited to the allowance for loan losses.

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

Included in the review of individual loans are those that are impaired, under the provisions of SFAS 114. A loan is considered impaired when, based on current information and events, it is probable that the Group will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral, if the loan is collateral dependent. Loans are individually evaluated for impairment, except large groups of small balance homogeneous loans that are collectively evaluated for impairment under the provisions of SFAS No. 5, and loans that are recorded at fair value or at the lower of cost or market. The portfolios of mortgage and consumer loans are considered homogeneous, and are evaluated collectively for impairment. For the commercial loans portfolio, all loans over $250,000 and over 90-days past due are evaluated for impairment, under the provisions of SFAS 114. At June 30, 2008, the total investment in impaired loans was $1.6 million, compared to $1.1 million at December 31, 2007. Impaired loans are measured based on the fair value of collateral method, since all impaired loans during the period were collateral dependant. The Group determined that no specific impairment allowance was required for such loans, as the loan collateral fair value exceeds the loan s book value.

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

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

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

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FINANCIAL CONDITION
TABLE 7 BANK ASSETS SUMMARY AND COMPOSITION
AS OF JUNE 30, 2008 AND 2007, AND DECEMBER 31, 2007
(In thousands)

	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Investments:				
Mortgage-backed securities	$ 3,401,693	$ 2,602,766	30.7%	$ 1,910,348
U.S. Government and agency obligations	982,496	1,698,748	-42.2%	1,618,549
P.R. Government and agency obligations	72,232	72,667	-0.6%	100,070
Other Securities	165,344	189,109	-12.6%	42,482
FHLB stock	22,062	20,658	6.8%	13,908
Other Investments	150	1,662	-91.0%	31,770
	4,643,977	**4,585,610**	**1.27%**	**3,717,127**
Loans:				
Loans receivable	**1,187,920**	**1,173,055**	**1.3%**	**1,214,577**
Allowance for loan losses	(11,885)	(10,161)	17.0%	(8,432)
Loans receivable, net	**1,176,035**	**1,162,894**	**1.1%**	**1,206,145**
Mortgage loans held-for-sale	42,122	16,672	152.7%	66,032
Total loans receivable, net	**1,218,157**	**1,179,566**	**3.3%**	**1,272,177**
Securities sold but not yet delivered			0.0%	46,461
Total securities and loans	**5,862,134**	**5,765,176**	1.7%	**5,035,765**
Other assets:				
Cash and due from banks	56,486	88,983	-36.5%	91,418
Accrued interest receivable	42,842	52,315	-18.1%	45,807
Premises and equipment, net	21,378	21,779	-1.8%	19,390
Deferred tax asset, net	17,249	10,362	66.5%	18,005
Foreclosed real estate, net	4,906	4,207	16.6%	4,971
Investment in equity indexed options	27,641	40,709	-32.1%	43,358
Other assets	27,543	16,324	68.7%	31,935
Total other assets	**198,045**	**234,679**	**-15.6%**	**254,884**
Total assets	**$ 6,060,179**	**$ 5,999,855**	**1.0%**	**$ 5,290,649**

Investments portfolio composition:			
Mortgage-backed securities	73.3%	56.8%	51.4%
U.S. Government securities	21.2%	37.0%	43.5%
P.R. Government securities	1.6%	1.6%	2.7%
FHLB stock and other investments	4.0%	4.6%	2.4%
	100.0%	**100.0%**	**100.0%**

At June 30, 2008, the Group s total assets amounted to $6.060 billion, an increase of 1.0%, when compared to $6.0 billion at December 31, 2007. Interest-earning assets were $5.862 billion at June 30, 2008, a 1.7% increase compared to $5.765 billion at December 31, 2007.

Investments principally consist of U.S. government and agency obligations, mortgage-backed securities, collateralized mortgage obligations, and Puerto Rico government bonds. At June 30, 2008, the investment portfolio increased 1.27% to $4.644 billion, from $4.586 billion at December 31, 2007. For further details regarding the Group s investment securities, refer to Note 2 of the unaudited consolidated financial statements.

At June 30, 2008, the Group s loan portfolio, the second largest category of the Group s interest-earning assets, amounted to $1.218 billion, an increase of 3.3% when compared to $1.180 billion at December 31, 2007. The Group s loan portfolio is mainly comprised of residential loans, home equity loans, and commercial loans collateralized by mortgages on real estate located in Puerto Rico. Loan production and purchases for the quarter and six-month periods ended June 30, 2008, increased 7.2% and 0.1%, respectively, to $92.6 million and $158.9 million, compared to the quarter and six-month period ended June 30, 2007.

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TABLE 8 NON-PERFORMING ASSETS
AS OF JUNE 30, 2008 AND 2007, AND DECEMBER 31, 2007
(In thousands)

	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Non-performing assets:				
Non-accruing loans	$ 30,440	$ 27,347	11.3%	$ 19,902
Accruing loans	38,393	38,762	-1.0%	30,598
Total non-performing loans	68,833	66,109	4.1%	50,500
Foreclosed real estate	4,906	4,207	16.6%	4,971
Total non-performing assets	**$ 73,739**	**$ 70,316**	**4.9%**	**$ 55,471**
Non-performing assets to total assets	**1.22%**	**1.17%**		**1.05%**

TABLE 9 NON-PERFORMING LOANS
AS OF JUNE 30, 2008 AND 2007, AND DECEMBER 31, 2007
(In thousands)

	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Non-performing loans:				
Mortgage	$ 64,867	$ 62,878	3.2%	$ 46,626
Commercial, mainly secured by real estate	3,026	2,413	25.4%	3,204
Consumer	940	818	14.9%	670
Total	**$ 68,833**	**$ 66,109**	**4.1%**	**$ 50,500**
Non-performing loans composition:				
Mortgage	94.2%	95.1%		92.3%
Commercial, mainly secured by real estate	4.4%	3.7%		6.3%
Consumer	1.4%	1.2%		1.3%
Total	**100.00%**	**100.00%**		**100.00%**
Non-performing loans to:				
Total loans	**5.60%**	**5.56%**	**0.72%**	**3.94%**
Total assets	**1.14%**	**1.10%**	**3.6%**	**0.95%**

During the second quarter of 2008, the Group observed the first sequential quarter reduction in non-performing loans in two years, from $69.2 million at March 31, 2008, to $68.8 million at June 30, 2008.

At June 30, 2008, the allowance for loan losses to non-performing loans coverage ratio was 17.27%. Detailed information concerning each of the items that comprise non-performing assets follows:

Mortgage loans are placed on a non-accrual basis when they become 365 days or more past due and are written-down, if necessary, based on the specific evaluation of the collateral underlying the loan. At June 30, 2008, the Group s non-performing mortgage loans totaled $64.9 million (94.2% of the Group s non-performing loans), a 3.2% increase from the $62.9 million (95.1% of the Group s non-performing loans) reported at December 31, 2007. Non-performing loans in this category are primarily residential mortgage loans.

Commercial loans are placed on non-accrual status when they become 90 days or more past due and are written-down, if necessary, based on the specific evaluation of the underlying collateral, if any. At June 30, 2008, the Group s non-performing commercial loans amounted to $3.0 million (4.4% of the Group s non-performing loans), a 25.4% increase when compared to non-performing commercial loans of $2.4 million reported at December 31, 2007 (3.7% of the Group s non-performing loans). Most of this portfolio is collateralized by commercial real estate properties.

Consumer loans are placed on non-accrual status when they become 90 days past due and written-off when payments are delinquent 120 days in personal loans and 180 days in credit cards and personal lines of credit. At June 30, 2008, the Group s non-performing consumer loans amounted to $940,000 (1.4% of the Group s total non-performing loans), an increase from the $818,000 reported at December 31, 2007 (1.2% of total non-performing loans).

Foreclosed real estate is initially recorded at the lower of the related loan balance or fair value at the date of foreclosure. Any excess of the loan balance over the fair value of the property is charged against the allowance for loan losses. Subsequently, any excess of the carrying value over the estimated fair value less disposition cost is charged to operations. Proceeds from sales of foreclosed real estate properties during the quarter ended June 30, 2008, totaled approximately $1.5 million.

At June 30, 2008, the Group s total liabilities were $5.759 billion, 2.1% higher than the $5.640 billion reported at December 31, 2007. Deposits and borrowings, the Group s funding sources, amounted to $5.713 billion at June 30, 2008, an increase of 3.8% when compared to $5.503 billion reported at December 31, 2007. At June 30, 2008, borrowings represented 73.9% of interest-bearing liabilities and deposits represented 26.1%, versus 77.4% and 22.6%, respectively, at December 31, 2007.

The FHLB system functions as a source of credit to financial institutions that are members of a regional Federal Home Loan Bank. As a member of the FHLB, the Group can obtain advances from the FHLB, secured by the FHLB stock owned by the Group, as well as by certain of the Group s mortgages and investment securities. FHLB advances, including accrued interest, totaled $331.9 million at June 30, 2008, and December 31, 2007. The Group has the capacity to expand FHLB funding up to a maximum of $500.0 million based on the assets pledged by the Group on the FHLB.

At June 30, 2008, deposits reached $1.492 billion, up 19.7%, compared to the $1.246 billion reported at December 31, 2007. The increase is deposits was driven by savings accounts, which totaled $407.9 million at June 30, 2008, up 5.2% when compared to the $387.8 million reported at December 31, 2007, and also by certificates of deposit, which increased $219.6 million during the quarter ended June 30, 2008, from $736.2 million at December 31, 2007, to $955.8 million.

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TABLE 10 LIABILITIES SUMMARY AND COMPOSITION
AS OF JUNE 30, 2008 AND 2007, AND DECEMBER 31, 2007
(In thousands)

	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Deposits:				
Non-interest bearing deposits	$ 55,936	$ 50,149	11.5%	$ 44,867
Now accounts	68,195	68,994	-1.2%	66,819
Savings accounts	407,907	387,788	5.2%	326,124
Certificates of deposit	955,790	736,186	29.8%	885,184
	1,487,828	**1,243,117**	**19.7%**	**1,322,994**
Accrued interest payable	4,591	3,303	39.0%	6,668
	1,492,419	**1,246,420**	**19.7%**	**1,329,662**
Borrowings:				
Repurchase agreements	3,810,752	3,861,411	-1.3%	3,283,796
Advances from FHLB	331,895	331,898	0.0%	180,895
Subordinated capital notes	36,083	36,083	0.0%	36,083
Federal funds purchased and other short term borrowings	41,583	27,460	51.4%	24,641
	4,220,313	**4,256,852**	**-0.9%**	**3,525,415**
Total deposits and borrowings	**5,712,732**	**5,503,272**	**3.8%**	**4,855,077**
Securities purchased but not yet received	23,103	111,431	-79.3%	100,067
Other liabilities	23,177	25,691	-9.8%	22,030
Total liabilities	**$ 5,759,012**	**$ 5,640,394**	**2.1%**	**$ 4,977,174**
Deposits portfolio composition percentages:				
Non-interest bearing deposits	3.8%	4.0%		3.4%
Now accounts	4.6%	5.6%		5.1%
Savings accounts	27.4%	31.2%		24.7%
Certificates of deposit	64.2%	59.2%		66.9%
	100.0%	**100.0%**		**100.0%**
Borrowings portfolio composition percentages:				
Repurchase agreements	90.3%	90.7%		93.2%

Advances from FHLB	7.9%	7.8%	5.1%
Subordinated capital notes	0.8%	0.8%	1.0%
Federal funds purchased and other short term borrowings	1.0%	0.7%	0.7%
	100.0%	**100.0%**	**100.0%**
Repurchase agreements			
Amount outstanding at quarter-end	$ 3,810,752	$ 3,861,411	$ 3,283,796
Daily average outstanding balance	$ 3,828,410	$ 3,154,369	$ 3,287,489
Maximum outstanding balance at any month-end	$ 3,847,633	$ 3,861,411	$ 3,319,688

Stockholders Equity

At June 30, 2008, the Group s total stockholders equity was $301.2 million, a 16.2% decrease when compared to $359.5 million at December 31, 2007. The change reflects a reduction in the fair value of the available-for-sale investment securities portfolio, primarily due to the widening of credit spreads in the second quarter of 2008. The Group s capital ratios remain above regulatory capital requirements. At June 30, 2008, the Tier 1 Leverage Capital Ratio was 6.80%, the Tier 1 Risk-Based Capital Ratio was 17.26%, and the Total Risk-Based Capital Ratio was 17.76%.

The Bank is considered well-capitalized under the regulatory framework for prompt corrective action if it meets or exceeds a Tier I Risk-Based Capital Ratio of 6%, a Total Risk-Based Capital Ratio of 10% and a Leverage Capital Ratio of 5%. In addition, the Group and the Bank meet the following minimum capital requirements: a Tier I Risk-Based Capital Ratio of 4%, a Total Risk-Based Capital Ratio of 8% and a Tier 1 Leverage Capital Ratio of 4%. As shown in Table 11, the Group exceeds these benchmarks due to the high level of capital and the quality and conservative nature of its assets.

Under the regulatory framework for prompt corrective action, banks that meet or exceed a Tier I Capital Risk-Based ratio of 6%, a Total Capital Risk-Based Ratio of 10% and a Leverage Ratio of 5% are considered well capitalized. The Bank exceeds those regulatory capital requirements.

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The following are the consolidated capital ratios of the Group at June 30, 2008 and 2007, and December 31, 2007:

TABLE 11 CAPITAL, DIVIDENDS AND STOCK DATA
AS OF JUNE 30, 2008 AND 2007, AND DECEMBER 31, 2007
(In thousands, except per share data)

	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Capital data:				
Stockholders equity	$ 301,167	$ 359,461	-16.2%	$ 313,475
Regulatory Capital Ratios data:				
Leverage Capital Ratio	6.80%	6.69%	1.6%	7.23%
Minimum Leverage Capital Ratio Required	4.00%	4.00%		4.00%
Actual Tier 1 Capital	$ 413,767	$ 396,309	4.4%	$ 381,489
Minimum Tier 1 Capital Required	$ 243,414	$ 236,847	2.8%	$ 210,972
Tier 1 Risk-Based Capital Ratio	17.26%	18.59%	-7.2%	19.32%
Minimum Tier 1 Risk-Based Capital Ratio Required	4.00%	4.00%		4.00%
Actual Tier 1 Risk-Based Capital	$ 413,767	$ 396,309	4.4%	$ 381,489
Minimum Tier 1 Risk-Based Capital Required	$ 95,867	$ 85,292	12.4%	$ 78,970
Total Risk-Based Capital Ratio	17.76%	19.06%	-6.8%	19.75%
Minimum Total Risk-Based Capital Ratio Required	8.00%	8.00%		8.00%
Actual Total Risk-Based Capital	$ 425,652	$ 406,470	4.7%	$ 389,921
Minimum Total Risk-Based Capital Required	$ 191,735	$ 170,583	12.4%	$ 157,940
Stock data:				
Outstanding common shares, net of treasury	24,292	24,121	0.7%	24,520
Book value	$ 9.60	$ 12.08	-20.5%	$ 9.99
Market price at end of period	$ 14.26	$ 13.41	6.3%	$ 10.91

Market capitalization	$ 346,404	$ 323,463	7.1%	$ 267,517

	June 30, 2008	June 30, 2007	Variance %
Common dividend data:			
Cash dividends declared	$ 6,804	$ 6,861	-0.8%
Cash dividends declared per share	$ 0.28	$ 0.28	0.0%
Payout ratio	23.53%	45.90%	-48.7%
Dividend yield	3.06%	4.62%	-33.8%

The following provides the high and low prices and dividend per share of the Group s stock for each quarter of the last three years. Common stock prices and cash dividend per share were adjusted to give retroactive effect to the stock dividend declared on the Group s common stock.

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Quarter ended	Price High	Price Low	Cash Dividend per share
2008			
June 30, 2008	20.57	14.26	0.14
March 31, 2008	23.28	12.79	0.14
2007			
December 31, 2007	14.70	11.12	0.14
September 30, 2007	11.63	8.57	0.14
June 30, 2007	12.42	10.81	0.14
March 31, 2007	14.04	11.65	0.14
2006			
December 31, 2006	13.57	11.47	0.14
September 30, 2006	12.86	11.82	0.14
June 30, 2006	13.99	11.96	0.14
March 31, 2006	14.46	12.41	0.14

At June 30, 2008 and December 31, 2007, the Bank was considered well capitalized under the FDIC regulatory framework for prompt corrective action. To be classified as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios set forth in the following table:

(In thousands)	June 30, 2008	December 31, 2007	Variance %	June 30, 2007
Oriental Bank and Trust Regulatory Capital Ratios:				
Total Tier 1 Capital to Total Assets	5.83%	5.80%	0.5%	5.85%
Actual Tier 1 Capital	$ 335,433	$ 331,552	1.2%	$ 302,160
Minimum Capital Requirement (4%)	$ 230,318	$ 228,768	0.7%	$ 206,615
Minimum to be well capitalized (5%)	$ 287,897	$ 285,960	0.7%	$ 258,269

Tier 1 Capital to Risk-Weighted Average	15.98%	16.61%	-3.8%	15.52%
Actual Tier 1 Risk-Based Capital	$ 335,433	$ 331,552	1.2%	$ 302,160
Minimum Capital Requirement (4%)	$ 83,946	$ 79,829	5.2%	$ 77,900
Minimum to be well capitalized (6%)	$ 125,920	$ 119,743	5.2%	$ 116,850
Total Capital to Risk-Weighted assets	16.55%	17.12%	-3.3%	15.95%
Actual Total Risk-Based Capital	$ 347,318	$ 341,713	1.6%	$ 310,592
Minimum Capital Requirement (8%)	$ 167,893	$ 159,657	5.2%	$ 155,800
Minimum to be well capitalized (10%)	$ 209,866	$ 199,572	5.2%	$ 194,750

The Group s common stock is traded on the New York Stock Exchange (NYSE) under the symbol OFG. At June 30, 2008, the Group s market capitalization for its outstanding common stock was $346.4 million ($14.26 per share).

On April 25, 2007, the Board of Directors adopted the Oriental Financial Group Inc. 2007 Omnibus Performance Incentive Plan (the Omnibus Plan), which was subsequently approved at the June 27, 2007 annual meeting of stockholders. The Omnibus Plan provides for equity-based compensation incentives through the grant of stock options, stock appreciation rights, restricted stock, restricted stock units and dividend equivalents, as well as equity-based performance awards. Refer to Note 1 of the accompanying unaudited consolidated financial statements for additional information regarding the Omnibus Plan.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
RISK MANAGEMENT
Background
The Group s risk management policies are established by the Board, implemented by management through the adoption of a risk management program overseen and monitored by the Chief Risk Officer and the Risk Management Committee (RMC). The Group has continued to refine and enhance its risk management program by strengthening policies, processes and procedures necessary to maintain effective risk management.
All aspects of the Group s business activities are susceptible to risk. Consequently, risk identification and monitoring are essential to risk management. As more fully discussed below, the Group s primary risks exposure include, market, interest rate, credit, liquidity, operational and concentration risks.
Market Risk
Market risk is the risk to earnings or capital arising from adverse movements in market rates or prices, such as interest rates or prices. The Group evaluates market risk together with interest rate risk (See Interest Rate Risk below).
The Group s financial results and capital levels are constantly exposed to market risk. The Board and management are primarily responsible for ensuring that the market risk assumed by the Group complies with the guidelines established by Board approved policies. The Board has delegated the management of this risk to the Asset and Liability Management Committee (ALCO) which is composed of certain executive officers from the Group s business, treasury and finance areas. One of ALCO s primary goals is to ensure that the market risk assumed by the Group is within the parameters established in the policies adopted by the Board.
Interest Rate Risk
Interest rate risk is the exposure of the Group s earnings or capital to adverse movements in interest rates. It is a predominant market risk in terms of its potential impact on earnings.
The Group manages its asset/liability position in order to limit the effects of changes in interest rates on net interest income. ALCO is responsible for monitoring compliance with the market risk policies approved by the Board and adopting interest risk management strategies. In that role, ALCO oversees interest rate risk, liquidity management and other related matters.
In discharging its responsibilities, ALCO examines current and expected conditions in world financial markets, competition and prevailing rates in the local deposit market, liquidity, unrealized gains and losses in securities, recent or proposed changes to the investment portfolio, alternative funding sources and their costs, hedging and the possible purchase of derivatives such as swaps and caps, and any tax or regulatory issues which may be pertinent to these areas. ALCO approves funding decisions in light of the Group s overall growth strategies and objectives.
Each month, the Group performs a net interest income simulation analysis to estimate the potential change in future earnings from projected changes in interest rates. These simulations are carried out over a one to three-year time horizon, assuming gradual upward and downward interest rate movements of 200 basis points, achieved during a twelve-month period. Simulations are carried out in two ways:

(1) using the Group s static balance sheet as of the simulation date, and

(2) using a growing balance sheet based on recent growth patterns and strategies.

The balance sheet is divided into groups of assets and liabilities detailed by maturity or re-pricing and their corresponding interest yields and costs. As interest rates rise or fall, these simulations incorporate expected future lending rates, current and expected future funding sources and cost, the possible exercise of options, changes in prepayment rates, deposits decay and other factors which may be important in projecting the future growth of net interest income.
The Group uses an asset-liability management software to project future movements in the Group s balance sheet and income statement. The starting point of the projections generally corresponds to the actual values of the balance sheet on the date of the simulations.
These simulations are highly complex, and use many simplifying assumptions that are intended to reflect the general behavior of the Group over the period in question. There can be no assurance that actual events will match these assumptions in all cases. For this reason, the results of these simulations are only approximations of the true

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sensitivity of net interest income to changes in market interest rates. The following table presents the results of the simulations at June 30, 2008, assuming a one-year time horizon:

	Net Interest Income Risk (one year projection)			
	Static Balance Sheet		Growing simulation	
Change in interest rate	Amount Change	Percent Change	Amount Change	Percent Change
(In thousands)				
+ 200 Basis points	$ (20,070)	-17.45%	$ (14,020)	-11.96%
+ 100 Basis points	$ (7,823)	-6.80%	$ (5,323)	-4.54%
- 100 Basis points	$ 771	0.67%	$ 781	0.67%
- 200 Basis points	$ (3,431)	-2.98%	$ (5,539)	-4.72%

Future net interest income could be affected by the Group s investments in callable securities, prepayment risk related to mortgage loans and mortgage-backed securities, and its structured repurchase agreements and advances from the FHLB. As part of the strategy to limit the interest rate risk and reduce the re-pricing gaps of the Group s assets and liabilities, the maturity and the repricing frequency of the liabilities has been extended to longer terms. The concentration of long-term fixed rate securities has also been reduced.

The Group uses derivative instruments and other strategies to manage its exposure to interest rate risk caused by changes in interest rates beyond management s control. The following summarizes strategies, including derivative activities, used by the Group in managing interest rate risk:

Interest rate swaps Interest rate swap agreements generally involve the exchange of fixed and floating rate interest payment obligations without the exchange of the underlying principal. The interest rate swaps have been utilized to convert short term repurchase agreements into fix rate to better match the repricing nature of these borrowings. There were no outstanding interest rate swaps at June 30, 2008, or December 31, 2007.

Structured borrowings The Group uses structured repurchase agreements and advances from the FHLB, with embedded call options, to reduce the Group s exposure to interest rate risk by lengthening the contractual maturities of its liabilities, while keeping funding costs low. For further details regarding the Group s structured borrowings, refer to Note 6 of the unaudited consolidated financial statements.

The Group offers its customers certificates of deposit with an option tied to the performance of the Standard & Poor s 500 stock market index. At the end of five years, the depositor receives a minimum return or a specified percentage of the average increase of the month-end value of the stock index. The Group uses option agreements with major money center banks and major broker-dealer companies to manage its exposure to changes in those indexes. Under the terms of the option agreements, the Group receives the average increase in the month-end value of the corresponding index in exchange for a fixed premium. The changes in fair value of the options purchased and the options embedded in the certificates of deposit are recorded in earnings.

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

At June 30, 2008, and December 31, 2007, the fair value the purchased options used to manage the exposure to the stock market on stock indexed deposits represented an asset of $27.6 million and $40.7 million, respectively; and the options sold to customers embedded in the certificates of deposit and recorded as deposits in the unaudited consolidated statement of financial condition, represented a liability of $26.2 million and $38.8 million, respectively.

Credit Risk

Credit risk is the possibility of loss arising from a borrower or counterparty in a credit-related contract failing to perform in accordance with its terms. The principal source of credit risk for the Group s is its lending activities. (Refer to the Allowance for Loan Losses and Non-Performing Assets section for further details.)

The Group manages its credit risk through a comprehensive credit policy which establishes sound underwriting standards, by monitoring and evaluating loan portfolio quality, and by the constant assessment of reserves and loan concentrations. The Group also employs proactive collection and loss mitigation practices.

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The Group may also encounter risk of default in relation to its securities portfolio. The securities held by the Group are principally mortgage-backed securities and U.S. Treasury and agency securities. Thus, a substantial portion of these instruments are guaranteed by mortgages, a U.S. government-sponsored entity or the full faith and credit of the U.S. government, and are deemed to be of the highest credit quality. At June 30, 2008, mortgage-backed securities include approximately $710.0 million in non-agency collateralized mortgage obligations with unrealized losses of $53.4 million in the Group s available-for-sale investment securities portfolio. These obligations are collateralized by pools of mortgage loans originated in the U.S., and are senior classes having subordination of losses ranging from 4.7% to 16.6%, which provide the capacity to absorb estimated collateral losses. These issues, including one that is backed by Alternative-A (Alt-A) loan collateral originated in 2006, are rated AAA by Standard & Poor s and Aaa by Moody s.

The unrealized loss position is a reflection of the recent dislocations seen in the financial and credit markets, which have created a significant widening in the market s credit spreads. The underlying reference long portfolios (collateral) on the structures are substantively investment grade, they have performed adequately, there have been no defaults to date, and none of our structured credit investments have been downgraded.

Management s Credit Committee, composed of the Group s Chief Executive Officer, Chief Credit Risk Officer and other senior executives, has primary responsibility for setting strategies to achieve the Group s credit risk goals and objectives. Those goals and objectives are set forth in the Group s Credit Policy.

Liquidity Risk

Liquidity risk is the risk of the Group not being able to generate sufficient cash from either assets or liabilities to meet obligations as they become due, without incurring substantial losses. The Group s cash requirements principally consist of deposit withdrawals, contractual loan funding, repayment of borrowings as they mature, and funding of new and existing investment as required.

Effective liquidity management requires that the Group have sufficient cash available at all times to meet its financial commitments, finance planned growth and have a reasonable safety margin for normal as well as unexpected cash needs. ALCO is responsible for managing the Group s liquidity risk in accordance with the policies adopted by the Board. In discharging its liquidity risk management obligations, ALCO approves operating and contingency procedures and monitors their implementation. The Group s Treasurer and CIO is responsible for the implementation of the liquidity risk management policies adopted by the Board and the operating and contingency procedures adopted by ALCO, and for monitoring the Group s liquidity position on an ongoing basis. Using measures of liquidity developed by the Group s Treasury Division under several different scenarios, the Treasury Division, ALCO and the Board review the Group s liquidity position on a daily, monthly and quarterly basis, respectively.

The Group meets its liquidity management objectives by maintaining (i) liquid assets in the form of investment securities,(ii) sufficient unused borrowing capacity in the national money markets, and achieving (iii) consistent growth in core deposits. At June 30, 2008, the Group had approximately $245.3 million in investments available to cover liquidity needs. Additional asset-driven liquidity is provided by the availability of loan assets to pledge. These sources, in addition to the Group s 6.80% average equity capital base, provide a stable funding base.

The Group utilizes different sources of funding to help ensure that adequate levels of liquidity are available when needed. Diversification of funding sources is of great importance as it protects the Group s liquidity from market disruptions. The principal sources of short-term funds are deposits, securities sold under agreements to repurchase, and lines of credit with the FHLB. ALCO reviews credit availability on a regular basis. The Group securitizes and sells mortgage loans as supplemental source of funding. Long-term certificates of deposit as well as long-term funding through the issuance of notes have also provided additional funding. The cost of these different alternatives, among other things, is taken into consideration. The Group s principal uses of funds are the origination of loans and the repayment of maturing deposit accounts and borrowings.

Operational Risk

Operational risk is the risk of loss from inadequate or failed internal processes, personnel and systems or from external events. All functions, products and services of the Group are susceptible to operational risk.

The Group faces ongoing and emerging risk and regulatory pressure related to the activities that surround the delivery of banking and financial products. Coupled with external influences such as market conditions, security risks, and legal risk, the potential for operational and reputational loss has increased. In order to mitigate and control operational risk, the Group has developed, and continues to enhance, specific internal controls, policies and procedures that are designed to identify and manage operational risk at appropriate levels throughout the organization. The purpose of these policies and procedures is to provide reasonable assurance that the Group s business operations are functioning within established limits.

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The Group classifies operational risk into two major categories: business specific and corporate-wide affecting all business lines. For business specific risks, a risk assessment group works with the various business units to ensure consistency in policies, processes and assessments. With respect to corporate wide risks, such as information security, business recovery, legal and compliance, the Group has specialized groups, such as the office of the General Counsel, Information Security, Corporate Compliance, Information Technology and Operations. These groups assist the lines of business in the development and implementation of risk management practices specific to the needs of the business groups. All these matters are reviewed and discussed in the RMC.

The Group is subject to extensive regulation in the different jurisdictions in which it conducts its business, and this regulatory scrutiny has significantly increased over the last several years. The Group has established and continues to enhance procedures based on legal and regulatory requirements that are reasonably designed to ensure compliance with all applicable statutory and regulatory requirements. The Group has a corporate compliance function, headed by a Senior Compliance Officer who reports to the Chief Risk Officer and is responsible for the oversight of regulatory compliance and implementation of an enterprise-wide compliance program.

Concentration Risk

Substantially all of the Group s business activities and a significant portion of its credit exposure are concentrated in Puerto Rico. As a consequence, the Group s profitability and financial condition may be adversely affected by an extended economic slowdown, adverse political or economic developments in Puerto Rico or the effects of a natural disaster, all of which could result in a reduction in loan originations, an increase in non-performing assets, an increase in foreclosure losses on mortgage loans, and a reduction in the value of its loans and loan servicing portfolio.

Puerto Rico is currently in a general economic slowdown that has caused a reduction in private sector employment and consumer spending. These economic concerns and uncertainties in the private and public sectors have had an adverse effect in the credit quality of our loan portfolios as delinquency rates have increased in the short-term and may continue to increase until the economy stabilizes. The reduction in consumer spending may continue to impact growth in our other interest and non-interest revenue sources.

Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

Internal Control over Financial Reporting

There were no changes in the Group s internal control over financial reporting (as such term is defined on rules 13a-15(e) and 15d-15(e) under the Exchange Act) during the quarter ended June 30, 2008.

PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

On August 11, 2000, the Group filed a lawsuit in the United States District Court for the District of Puerto Rico (the Court) against Federal Insurance Company, Inc. (FIC) for breach of insurance contract, breach of covenant of good faith and fair dealing and damages. On October 3, 2005, a jury rendered a verdict of $7.5 million in favor of the Group (the 2005 Verdict). The jury could not reach a decision on a portion of the Group s claim, thus forcing a new trial. After retrial of that portion of the Group s claim, on August 14, 2007, a jury rendered a verdict in favor of FIC and against the Group (the 2007 Verdict). Judgment pursuant to the aforementioned 2005 and 2007 verdicts was entered on August 15, 2007. By an Opinion and Order dated July 31, 2008, the Court set aside the portion of the 2005 Verdict granting the Group consequential damages in the amount of $7,078,640.60, and reaffirmed the 2007 Verdict. The Court upheld the award of $453,000 to the Group under the 2005 Verdict. The Group is considering its options with respect to the Court s decisions described above.

The Group has not recognized any income on these claims since several post-trial motions have not been ruled upon yet and appellate rights have not been exhausted. Thus, the amount to be collected cannot be determined at this time. In addition, the Group and its subsidiaries are defendants in a number of legal proceedings incidental to their business. The Group is vigorously contesting such claims. Based upon a review by legal counsel and the

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development of these matters to date, Management is of the opinion that the ultimate aggregate liability, if any, resulting from these claims will not have a material adverse effect on the Group s financial condition or results of operations.

Item 1A. RISK FACTORS

There have been no material changes to the risk factors as previously disclosed under Item 1A to Part 1 of the Group s annual report on Form 10-K for the fiscal year ended December 31, 2007.

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

a) None

b) Not applicable

c) Purchases of equity securities by the issuer and affiliated purchasers.

On July 27 2007, the Board approved a new stock repurchase program pursuant to which the Group is authorized to purchase in the open market up to $15.0 million of its outstanding share of common stock. The program was announced on July 31, 2007. The shares of common stock so repurchased are to be held by the Group as treasury shares. The new program will substitute the previous program approved on August 30, 2005.

There were no purchases of equity securities under this repurchase program during the quarter ended June 30 2008. The approximate dollar value of shares that may yet be repurchased under the plan amounted to $11.3 million at June 30, 2008.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None

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

The annual meeting of stockholders of the Group was held on June 18, 2008, for (i) the election of three directors for a three-year term expiring at the 2011 annual meeting of shareholders and until their successors are duly elected and qualified; (ii) to consider and approve an amendment to the Oriental Financial Group Inc. 2007 Omnibus Performance Incentive Plan to include a minimum one-year performance period for awards of performance shares and performance units, and a minimum three-year restriction period for awards of restricted stock and restricted units, and (iii) to ratify the selection of KPMG LLP as our independent auditors for the fiscal year ending December 31, 2008. There was no solicitation in opposition to the Board s nominees, which were all elected, the amendment to the Omnibus Plan was approved, and KMPG LLP was ratified. The voting results were as follows:

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	For		Withheld	
	#	%	#	%
Proposal 1-Election of Directors				
Three-year term				
Juan C. Aguayo	19,118,839	94.9%	1,029,205	5.1%
Pablo I. Altieri	19,008,963	94.3%	1,139,081	5.7%
Francisco Arriví	19,087,217	94.7%	1,060,827	5.3%

	For		Against		Abstain		Broker Non-Vote	
	#	%	#	%	#	%	#	%
Proposal 2-Approval of amendment to the Omnibus Plan	14,523,306	72.1%	577,220	2.9%	351,804	1.7%	4,695,714	23.3%

	For		Against		Abstain	
	#	%	#	%	#	%
Proposal 3-Ratification of selection of independent auditors	19,197,536	95.3%	458,359	2.3%	492,148	2.4%

Item 5. OTHER INFORMATION

a) None

b) None

Item 6. EXHIBITS

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

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Signatures

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

ORIENTAL FINANCIAL GROUP INC.
(Registrant)

By: /s/ José Rafael Fernández — Dated: August 8, 2008
José Rafael Fernández
President and Chief Executive Officer

By: /s/ Norberto González — Dated: August 8, 2008
Norberto González
Executive Vice President and Chief Financial Officer