

R&G FINANCIAL CORP  
Form 10-Q  
May 10, 2004

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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

t QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2004

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: 000-21137

**R&G FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

Puerto Rico

66-0532217

(State of incorporation or organization)

(I.R.S. Employer Identification No. )

280 Jesús T. Piñero Avenue  
Hato Rey, San Juan, Puerto Rico

00918

(Address of principal executive offices)

(Zip Code)

(787) 758-2424

(Registrant's telephone number, including area code)

Indicate by checkmark whether Registrant (a) 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 report (s) and (b) has been subject to such filing requirements for at least 90 days.

YES x NO o

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).

x Yes o NO

Number of shares of Class B Common Stock outstanding as of March 31, 2004: 29,539,464 (Does not include 21,559,584 Class A Shares of Common Stock which are exchangeable into Class B Shares of Common Stock at the

option of the holder.)

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**R&G FINANCIAL CORPORATION**

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**Table of Contents****PART 1-FINANCIAL INFORMATION****ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS****R&G FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<b>(Unaudited)</b>	
	<b>(Dollars in thousands)</b>	
<b>ASSETS</b>		
Cash and due from banks	\$ 86,222	\$ 114,916
Money market investments:		
Securities purchased under agreements to resell	119,428	85,053
Time deposits with other banks	98,919	34,349
Mortgage loans held for sale, at lower of cost or market	271,378	315,691
Mortgage-backed and investment securities held for trading, at fair value	14,806	31,797
Trading securities pledged on repurchase agreements, at fair value	16,134	6,558
Mortgage-backed and investment securities available for sale, at fair value	1,930,429	1,805,360
Available for sale securities pledged on repurchase agreements, at fair value	1,283,163	1,215,287
Mortgage-backed and investment securities held to maturity, at amortized cost (estimated market value: 2004 - \$15,415; 2003 - \$14,940)	15,345	14,883
Held to maturity securities pledged on repurchase agreements, at amortized cost (estimated market value: 2004 - \$61,502; 2003 - \$65,248)	59,554	63,317
Federal Home Loan Bank stock, at cost	104,479	100,461
Loans receivable, net	4,196,730	4,048,507
Accounts receivable, including advances to investors, net	49,374	38,195
Accrued interest receivable	44,528	42,527
Servicing asset, net	112,467	119,610
Premises and equipment, net	44,772	42,782
Other assets	136,450	119,587
	<b>\$8,584,178</b>	<b>\$ 8,198,880</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Liabilities:</b>		
Deposits	\$3,709,892	\$ 3,555,764
Federal funds purchased		21,000
Securities sold under agreements to repurchase	2,339,910	2,220,795
Notes payable	166,394	192,259
Advances from FHLB	1,098,600	1,129,600
Other borrowings	265,339	157,670
Accounts payable and accrued liabilities	206,554	158,006
Other liabilities	14,958	13,433

	<u>7,801,647</u>	<u>7,448,527</u>
Commitments and contingencies (see Note 7)		
Stockholders equity:		
Preferred stock, \$.01 par value, 20,000,000 shares authorized:		
Non-cumulative perpetual Monthly Income Preferred Stock, \$25 liquidation value:		
7.40% Series A, 2,000,000 shares authorized, issued and outstanding	50,000	50,000
7.75% Series B, 1,000,000 shares authorized, issued and outstanding	25,000	25,000
7.60% Series C, 2,760,000 shares authorized, issued and outstanding	69,000	69,000
7.25% Series D, 2,760,000 shares authorized, issued and outstanding	69,000	69,000
Common stock:		
Class A - \$.01 par value, 40,000,000 shares authorized, 21,559,584 issued and outstanding	216	216
Class B - \$.01 par value, 60,000,000 shares authorized, 29,539,464 issued and outstanding (2003 - 29,506,715)	295	295
Additional paid-in capital	115,368	115,017
Retained earnings	417,121	387,036
Capital reserves	25,103	25,103
Accumulated other comprehensive income, net of tax	<u>11,428</u>	<u>9,686</u>
	<u>782,531</u>	<u>750,353</u>
	<u>\$8,584,178</u>	<u>\$ 8,198,880</u>

The accompanying notes are an integral part of these statements.

**Table of Contents****R&G FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF INCOME**

	<b>Three month period ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Unaudited)</b>	
	<b>(Dollars in thousands except for per share data)</b>	
Interest income:		
Loans	\$ 68,169	\$ 51,955
Money market and other investments	7,094	8,618
Mortgage-backed securities	32,368	27,683
	<hr/>	<hr/>
Total interest income	107,631	88,256
	<hr/>	<hr/>
Interest expense:		
Deposits	23,703	21,693
Securities sold under agreements to repurchase	13,513	12,771
Notes payable	1,469	1,870
Other	13,232	9,701
	<hr/>	<hr/>
Total interest expense	51,917	46,035
	<hr/>	<hr/>
Net interest income	55,714	42,221
Provision for loan losses	(6,470)	(4,220)
	<hr/>	<hr/>
Net interest income after provision for loan losses	49,244	38,001
	<hr/>	<hr/>
Non-interest income:		
Net gain on origination and sale of loans	39,893	33,017
Loan administration and servicing fees	9,317	13,201
Service charges, fees and other	8,912	5,721
	<hr/>	<hr/>
	58,122	51,939
	<hr/>	<hr/>

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Total revenues	107,366	89,940
	<u>                    </u>	<u>                    </u>
Non-interest expenses:		
Employee compensation and benefits	16,700	15,147
Office occupancy and equipment	6,380	5,702
Other administrative and general	31,243	30,543
	<u>                    </u>	<u>                    </u>
	54,323	51,392
	<u>                    </u>	<u>                    </u>
Income before income taxes	53,043	38,548
	<u>                    </u>	<u>                    </u>
Income tax expense:		
Current	13,505	5,940
Deferred	998	3,467
	<u>                    </u>	<u>                    </u>
	14,503	9,407
	<u>                    </u>	<u>                    </u>
Net income	\$ 38,540	\$ 29,141
	<u>                    </u>	<u>                    </u>
Earnings per common share - Basic	\$ 0.68	\$ 0.49
	<u>                    </u>	<u>                    </u>
- Diluted	\$ 0.67	\$ 0.49
	<u>                    </u>	<u>                    </u>
Weighted average number of shares outstanding - Basic	51,089,482	51,034,079
- Diluted	51,326,343	51,271,139

The accompanying notes are an integral part of these statements.

Table of Contents**R&G FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	<b>Three month period ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Unaudited)</b>	
	<b>(Dollars in thousands)</b>	
Net income	\$38,540	\$29,141
Other comprehensive income, before tax:		
Unrealized (losses) gains :		
Cash flow hedges	(2,696)	340
Investment securities:		
Arising during period	5,486	(4,728)
Less: Reclassification adjustments for losses (gains) included in net income	13	(106)
	5,499	(4,834)
Other comprehensive gain (loss) before income taxes	2,803	(4,494)
Income tax (expense) benefit related to items of other comprehensive income	(1,062)	1,757
Other comprehensive income (loss), net of tax	1,741	(2,737)
Comprehensive income, net of tax	\$40,281	\$26,404

The accompanying notes are an integral part of these statements.



**Table of Contents****R&G FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Three month period ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Unaudited)</b>	
	<b>(Dollars in thousands)</b>	
Cash flows from operating activities:		
Net income	\$ 38,540	\$ 29,141
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,138	2,134
Amortization of premium on investments and mortgage-backed securities, net	1,791	2,506
Scheduled amortization of servicing asset	5,479	5,597
Impairment charges on servicing asset	9,300	10,829
Provision for loan losses	6,470	4,220
Loss (gain) on sales of mortgage-backed and investment securities available for sale	13	(106)
Unrealized loss on trading securities and derivative instruments, net	2,206	803
Decrease (increase) in mortgage loans held for sale	57,648	(27,741)
Net decrease in securities held for trading	7,364	28,243
Increase in receivables	(13,181)	(4,792)
Increase in other assets	(9,420)	(8,940)
(Decrease) increase in notes payable and other borrowings	(25,928)	21,274
Increase in accounts payable and accrued liabilities	42,635	13,218
Increase in other liabilities	1,525	1,919
Total adjustments	89,040	49,164
Net cash provided by operating activities	127,580	78,305
Cash flows from investing activities:		
Purchases of investment securities available for sale and held to maturity	(570,929)	(770,127)
Proceeds from sales and redemption of securities available for sale	228,495	144,806
Principal repayments on mortgage-backed securities	164,030	242,240
Proceeds from sales of loans	206,293	24,488
Net originations of loans	(381,863)	(274,910)
Purchases of FHLB stock, net	(4,018)	(14,619)
Acquisition of premises and equipment	(4,839)	(3,815)

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Acquisition of servicing rights	(7,636)	(7,921)
	<u>          </u>	<u>          </u>
Net cash used in investing activities	(370,467)	(659,858)
	<u>          </u>	<u>          </u>
Cash flows from financing activities:		
Increase in deposits - net	154,128	199,610
Decrease in federal funds purchased	(21,000)	
Increase in securities sold under agreements to repurchase - net	119,115	341,577
(Repayments) advances from FHLB, net	(31,000)	18,000
Proceeds from issuance of long-term debt	100,000	
Proceeds from issuance of common stock	351	194
Cash dividends:		
Common stock	(4,484)	(3,353)
Preferred stock	(3,971)	(3,971)
Cash paid in lieu of fractional shares on stock split	(1)	
	<u>          </u>	<u>          </u>
Net cash provided by financing activities	313,138	552,057
	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	70,251	(29,496)
Cash and cash equivalents at beginning of period	234,318	197,643
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 304,569	\$ 168,147
	<u>          </u>	<u>          </u>
Cash and cash equivalents include:		
Cash and due from banks	\$ 86,222	\$ 101,132
Short-term investments		17,415
Securities purchased under agreements to resell	119,428	12,297
Time deposits with other banks	98,919	37,303
	<u>          </u>	<u>          </u>
	\$ 304,569	\$ 168,147
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these statements.

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**R&G FINANCIAL CORPORATION**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING ENTITY AND BASIS OF PRESENTATION**

***Reporting entity***

The accompanying unaudited consolidated financial statements include the accounts of R&G Financial Corporation (the Company), a diversified financial services company, and its wholly-owned subsidiaries, R-G Premier Bank of Puerto Rico (Premier Bank), a Puerto Rico commercial bank, R-G Crown Bank (Crown Bank), a Florida-based federal savings bank, R&G Mortgage Corp. (R&G Mortgage), Puerto Rico's second largest mortgage banker, R-G Investments Corporation, a Puerto Rico licensed securities broker-dealer, and Home & Property Insurance Corp., a Puerto Rico insurance agency. The Company, currently in its 32nd year of operations, operates as a financial holding company, pursuant to the provisions of the Gramm-Leach-Bliley Act of 1999, and is engaged in banking, mortgage banking, and securities and insurance brokerage through its subsidiaries.

Premier Bank and Crown Bank provide a full range of banking services, including residential, commercial and personal loans and a variety of deposit products. Premier Bank operates through thirty-one branches located mainly in the northeastern part of the Commonwealth of Puerto Rico. Crown Bank operates in the Orlando and Tampa/St. Petersburg metropolitan areas through fifteen full service branches and seven commercial lending offices. Premier Bank also provides private banking and trust and other financial services to its customers. Premier Bank and Crown Bank are subject to the regulations of certain federal and Puerto Rico agencies, and undergo periodic examinations by those regulatory agencies.

Crown Bank is also engaged in the origination of FHA-insured, VA-guaranteed and privately insured first and second mortgage loans on residential real estate (1 to 4 families) in the States of New York, New Jersey, Connecticut, North Carolina and Florida, through its wholly-owned subsidiary, Continental Capital Corporation (Continental Capital).

R&G Mortgage is engaged primarily in the business of originating FHA-insured, VA-guaranteed, and privately insured first and second mortgage loans on residential real estate (1 to 4 families), directly and through its wholly-owned subsidiary, Mortgage Store of Puerto Rico, Inc. R&G Mortgage pools FHA and VA loans into GNMA mortgage-backed securities and collateralized mortgage obligation certificates for sale to investors. After selling the loans, it retains the servicing on the loans. R&G Mortgage is also a FNMA and FHLMC seller-servicer of conventional loans.

***Basis of presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles. However, in the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (principally consisting of normal recurring accruals) necessary for a fair presentation of the Company's financial condition as of March 31, 2004 and the results of operations and changes in its cash flows for the three months ended March 31, 2004 and 2003.

The results of operations for the three month periods ended March 31, 2004 are not necessarily indicative of the results to be expected for the year ending December 31, 2004. The unaudited consolidated financial statements and notes thereto should be read in conjunction with the audited financial statements and notes thereto for the year ended

December 31, 2003.

***Basis of consolidation***

All significant intercompany balances and transactions have been eliminated in the accompanying unaudited financial statements.

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***Recent accounting pronouncements***

**Accounting for Derivative Instruments and Hedging Activities**

On July 1, 2003, the Company adopted SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivatives instruments embedded in other contracts, and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of this Statement on July 1, 2003 had no significant effect on the consolidated financial condition or results of operations of the Company.

**Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity**

On July 1, 2003 the Company adopted SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. SFAS No. 150 covers a limited number of instruments that are to be classified as liabilities and specifies that such instruments embody obligations of the issuer and that, therefore, the issuer must classify them as liabilities.

Among the instruments specified by SFAS No. 150, mandatorily redeemable financial instruments had to be classified as liabilities. The Company had \$35 million of guaranteed preferred beneficial interest in company junior subordinated deferrable interest debentures ( trust preferred securities ) that had already been classified as other borrowings in its consolidated statements of financial condition as of June 30, 2003 and accordingly, the adoption of this Statement on July 1, 2003 did not have any effect on the Company s consolidated financial statements.

**Accounting for Consolidation of Variable Interest Entities**

In January 2003, the FASB issued FIN 46, Consolidation of Variable Interest Entities, and Interpretation of ARB No. 51 ( FIN 46 ). Under FIN 46, entities that would be assessed for consolidation are typically referred to as Special-Purposed Entities ( SPEs ), although non-SPE-type entities may also be subject to the guidance. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s

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activities or entitled to receive a majority of the entities residual returns, or both. FIN 46 was effective immediately for variable interest entities created after January 31, 2003. For variable interest entities created prior to February 1, 2003, the provisions of FIN 46 became effective October 1, 2003.

Under the provisions of FIN 46, effective July 1, 2003, the Company deconsolidated R&G Capital Trust I and II which had issued trust preferred securities prior to February 1, 2003. As discussed above, the Company had classified its \$35 million trust preferred securities as borrowings in its consolidated statements of financial condition prior to such deconsolidation. The primary effect of deconsolidating these trusts was to change the balance sheet classification of the liabilities from guaranteed preferred beneficial interest in company junior subordinated deferrable interest debentures to long-term debt.

The Company did not consolidate R&G Capital Trust IV created by the Company in August 2003, which issued \$15 million in trust preferred securities in a private placement, and R&G Capital Trust III which in October 2003 issued \$100 million of trust preferred securities in a public offering.

On March 31, 2004 the Company created R&G Capital Trust V which also issued \$100 million of trust preferred securities in a public offering. The requirements of FIN 46 were also applied to R&G Capital Trust V.

Based on interim guidance issued by the Federal Reserve Board, the deconsolidation of these vehicles pursuant to FIN 46 would not impact the Tier I capital treatment of the liabilities to the extent permitted under current regulations until notice is given to the contrary.

### **Accounting for Certain Loans and/or Debt Securities Acquired in a Transfer**

In November 2003, the Accounting Standards Executive Committee issued Statement of Position (SOP) No. 03-3, Accounting for Certain Loans and/or Debt Securities Acquired in a Transfer. This statement addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities acquired in a transfer if those differences are attributable to credit quality. This SOP does not apply to loans originated by the entity and it prohibits both the creating and carry over of valuation allowances in the initial accounting of all loans acquired in a transfer within the scope of this SOP. The prohibition of the carry over applies to purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination. This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Based on presently available information, management believes that adoption of this SOP will not have a significant effect on its consolidated financial statements.

### **Application of Accounting Principles to Loan Commitments**

On March 9, 2004, the SEC issued Staff Accounting Bulletin 105, Application of Accounting Principles to Loan Commitments, ( SAB 105 ) to inform registrants of the Staff's view that the fair value of the recorded loan commitments should not consider the expected future cash flows related to the associated servicing of the future loan. The provisions of SAB 105 must be applied to loan commitments accounted for as derivatives that are entered into after March 31, 2004. The Staff will not object to the application of existing accounting practices to loan commitments accounted for as derivatives that are entered into on or before March 31, 2004, with appropriate disclosures. On April 1, 2004, R&G Financial adopted the provisions of SAB 105. R&G Financial records the value of its mortgage loan commitments at fair market value for mortgages it intends to sell. R&G Financial does not currently include, and was not including, the value of mortgage servicing or any other internally-developed intangible assets in the valuation of its mortgage loan commitments. Therefore, the adoption of SAB 105 did not have an impact on the Company's financial condition or results of operations.

**NOTE 2 - EARNINGS PER SHARE**

Basic earnings per common share are computed by dividing net income (less preferred stock dividends) by the weighted average number of shares of common stock outstanding. The weighted average number of outstanding stock options granted in connection with the Company's Stock Option Plan (236,861 and 237,060 during the three months ended March 31, 2004 and 2003, respectively, after giving effect to stock split), is included in the weighted average number of shares for purposes of the diluted earnings per share computation. No other adjustments are made to the computation of basic earnings per share to arrive at diluted earnings per share.

Dividends per share on common stock declared and paid by the Company were as follows:

	<b>Three month period ended March 31,</b>	
<b>2004</b>		<b>2003</b>
\$0.0878		\$0.0653

**Table of Contents****NOTE 3 - INVESTMENT AND MORTGAGE-BACKED SECURITIES**

The carrying value and estimated fair value of investment and mortgage-backed securities by category are shown below. The fair value of investment securities is based on quoted market prices and dealer quotes.

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<u>          </u>	<u>          </u>
	<b>(Unaudited)</b>	
	<b>(Dollars in thousands)</b>	
<b>Mortgage-backed securities held for trading:</b>		
FHLMC certificates	\$ 30,885	\$ 33,245
	<u>          </u>	<u>          </u>
<b>Investment securities held for trading:</b>		
Municipal securities		446
Bank issued trust preferred securities		4,650
Other	55	14
	<u>          </u>	<u>          </u>
	55	5,110
	<u>          </u>	<u>          </u>
	\$ 30,940	\$ 38,355
	<u>          </u>	<u>          </u>



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	<b>March 31, 2004</b>		<b>December 31, 2003</b>	
	<b>Amortized cost</b>	<b>Fair value</b>	<b>Amortized cost</b>	<b>Fair value</b>
<b>(Unaudited)</b>				
<b>(Dollars in thousands)</b>				
<b>Mortgage-backed Securities Available for Sale:</b>				
Collateralized mortgage obligations (CMO):				
Due from one to five years	\$ 5,014	\$ 5,082	\$ 5,939	\$ 6,019
Due from five to ten years	42,522	42,571	20,889	20,873
Due over ten years	1,024,892	1,030,500	941,970	939,757
	<u>1,072,428</u>	<u>1,078,153</u>	<u>968,798</u>	<u>966,649</u>
CMO residuals (interest only), and interest only strips (IO s)	<u>131,575</u>	<u>132,845</u>	<u>107,058</u>	<u>107,957</u>
FNMA certificates:				
Due from one to five years	222	308	71	72
Due from five to ten years	94,016	94,077	87,989	87,101
Due over ten years	417,881	427,918	388,687	405,193
	<u>512,119</u>	<u>522,303</u>	<u>476,747</u>	<u>492,366</u>
FHLMC certificates:				
Due from one to five years	202	214	3	3
Due from five to ten years	44,870	44,531	20,308	19,955
Due over ten years	419,113	426,954	439,876	448,161
	<u>464,185</u>	<u>471,699</u>	<u>460,187</u>	<u>468,119</u>
GNMA certificates:				
Due from one to five years	1,055	1,089	50	52
Due from five to ten years	11,935	12,316	12,563	12,918
Due over ten years	332,446	335,357	346,568	350,217
	<u>345,436</u>	<u>348,762</u>	<u>359,181</u>	<u>363,187</u>

<u>2,525,743</u>	<u>2,553,762</u>	<u>2,371,971</u>	<u>2,398,278</u>
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**Investment Securities Available for Sale:**

U.S. Government and Agencies securities:

Due within one year	37,482	37,836	62,519	63,113
Due from one to five years	499,399	502,100	399,275	398,028
Due from five to ten years	47,562	49,067	79,388	81,042
	<u>584,443</u>	<u>589,003</u>	<u>541,182</u>	<u>542,183</u>