

OCEANFIRST FINANCIAL CORP

Form 10-Q

November 08, 2013

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2013**

.. **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 001-11713**

**OceanFirst Financial Corp.**

**(Exact name of registrant as specified in its charter)**

|   |  |
|---|--|
| <b>Delaware</b><br><b>(State or other jurisdiction of</b>                                   | <b>22-3412577</b><br><b>(I.R.S. Employer</b> |
| <b>incorporation or organization)</b>   | <b>Identification No.)</b>                   |
| <b>975 Hooper Avenue, Toms River, NJ</b><br><b>(Address of principal executive offices)</b> | <b>08753</b><br><b>(Zip Code)</b>            |
| <b>Registrant's telephone number, including area code: (732) 240-4500</b>                   |  |

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

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

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

|  |   |
|--|---|
| Large Accelerated Filer <input type="checkbox"/> | Accelerated Filer <input checked="" type="checkbox"/> |
| Non-accelerated Filer <input type="checkbox"/>   | Smaller Reporting Company <input type="checkbox"/>    |

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

As of November 1, 2013, there were 17,386,060 shares of the Registrant's Common Stock, par value \$.01 per share, outstanding.

**Table of Contents****OceanFirst Financial Corp.**

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**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****FINANCIAL SUMMARY**

(dollars in thousands, except per share amounts) At or for the Quarter Ended  
September 30, 2013    June 30, 2013    September 30, 2012

**SELECTED FINANCIAL CONDITION DATA:**

|                       |              |              |              |
|-----------------------|--------------|--------------|--------------|
| Total assets          | \$ 2,286,288 | \$ 2,305,664 | \$ 2,304,426 |
| Loans receivable, net | 1,522,425    | 1,505,680    | 1,545,640    |
| Deposits              | 1,768,914    | 1,703,746    | 1,739,974    |
| Stockholders' equity  | 213,769      | 216,278      | 219,687      |

**SELECTED OPERATING DATA:**

|                            |        |        |        |
|----------------------------|--------|--------|--------|
| Net interest income        | 17,544 | 17,544 | 18,000 |
| Provision for loan losses  | 700    | 800    | 1,400  |
| Other income               | 4,566  | 4,741  | 4,878  |
| Operating expenses         | 13,784 | 13,724 | 13,839 |
| Net income                 | 4,968  | 4,987  | 4,959  |
| Diluted earnings per share | 0.29   | 0.29   | 0.28   |

**SELECTED FINANCIAL RATIOS:**

|  |       |       |       |
|--|-------|-------|-------|
| Stockholders' equity per common share      | 12.30 | 12.29 | 12.19 |
| Cash dividend per share                    | 0.12  | 0.12  | 0.12  |
| Stockholders' equity to total assets       | 9.35% | 9.38% | 9.53% |
| Return on average assets (1)               | 0.86  | 0.87  | 0.86  |
| Return on average stockholders' equity (1) | 9.17  | 9.06  | 9.08  |
| Average interest rate spread               | 3.11  | 3.13  | 3.18  |
| Net interest margin                        | 3.20  | 3.21  | 3.28  |
| Operating expenses to average assets (1)   | 2.39  | 2.38  | 2.39  |
| Efficiency ratio                           | 62.34 | 61.58 | 60.49 |

**ASSET QUALITY:**

|  |           |           |           |
|--|-----------|-----------|-----------|
| Non-performing loans   | \$ 41,565 | \$ 45,900 | \$ 41,173 |
| Non-performing assets  | 45,824    | 49,320    | 44,801    |
| Allowance for loan losses as a percent of total loans receivable     | 1.35%     | 1.36%     | 1.17%     |
| Allowance for loan losses as a percent of total non-performing loans | 50.25     | 45.36     | 44.42     |
| Non-performing loans as a percent of total loans receivable          | 2.68      | 3.00      | 2.63      |
| Non-performing assets as a percent of total assets                   | 2.00      | 2.14      | 1.94      |

(1) Ratios are annualized

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**Table of Contents****Summary**

OceanFirst Financial Corp. is the holding company for OceanFirst Bank (the Bank), a community bank serving Ocean and Monmouth Counties in New Jersey. The term the Company refers to OceanFirst Financial Corp., OceanFirst Bank and all of the Bank's subsidiaries on a consolidated basis. The Company's results of operations are primarily dependent on net interest income, which is the difference between the interest income earned on interest-earning assets, such as loans and investments, and the interest expense on interest-bearing liabilities, such as deposits and borrowings. The Company also generates non-interest income such as income from loan sales, loan servicing, loan originations, trust and asset management services, the sale of investment products, merchant credit card services, deposit accounts, and other fees. The Company's operating expenses primarily consist of compensation and employee benefits, occupancy and equipment, marketing, data processing, federal deposit insurance and general and administrative expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory agencies.

Interest-earning assets, both loans and securities, are generally priced against longer-term indices, while interest-bearing liabilities, primarily deposits and borrowings, are generally priced against shorter-term indices. Beginning in the second half of 2011 and through the first quarter of 2013, the Company's net interest margin had generally contracted. Due to the low interest rate environment, high loan refinance volume caused yields on loans and mortgage-backed securities to trend downward. At the same time, the Company's asset mix shifted as higher-yielding loans decreased due to prepayments and the sale of newly-originated 30-year fixed-rate one-to-four family loans while lower-yielding securities increased. More recently, the Company's net interest margin has stabilized. Although high loan refinance volume and shifting asset mix continued into the second quarter of 2013, the Company's net interest margin nonetheless expanded slightly as the Company invested excess liquidity and managed funding costs lower. In the third quarter of 2013, refinance activity subsided and the Company was successful in growing commercial loans, resulting in a shift in asset mix from securities into loans. Based upon current economic conditions, the Federal Reserve has indicated that it intends to keep short-term interest rates at current levels through mid-2015 and decided to await more evidence that the economy was advancing before changing course on its monthly bond buying program. Longer-term interest rates have increased since earlier in the year, resulting in a steeper yield curve. While the impact of these factors on the Company's financial results is difficult to predict, management anticipates there may be further pressure on the net interest margin in subsequent quarters. Additionally, the increase in longer-term interest rates has reduced loan refinance activity, causing a decrease in loan sale volume and lower income from the net gain on the sale of loans. This trend is expected to continue as income from the sale of loans in subsequent quarters will likely fall below comparable prior year levels. In addition to the interest rate environment, the Company's results are affected by national and local economic conditions. Recent economic indicators point to some improvement in the economy, which expanded modestly in 2012 and through the first nine months of 2013. Labor market conditions also improved as the national unemployment rate in the first nine months of 2013 decreased over prior year levels. Despite these signs, the overall economy remains weak and the unemployment rate remains at an elevated level. Additionally, housing values remain significantly below their peak levels in 2006. These economic conditions have generally had an adverse impact on the Company's results of operations.

Highlights of the Company's financial results for the three and nine months ended September 30, 2013 were as follows:

Total assets increased to \$2.286 billion at September 30, 2013, from \$2.269 billion at December 31, 2012. Securities, in the aggregate, increased by \$35.5 million, to \$583.0 million at September 30, 2013, as compared to \$547.5 million at December 31, 2012. Loans receivable, net decreased \$775,000 at September 30, 2013, as compared to December 31, 2012 primarily due to prepayments and the sale of newly-originated 30-year fixed-rate one-to-four family loans. Commercial loans, however, grew \$29.9 million during this period and residential construction loans

increased \$8.1 million as homeowners rebuild from superstorm Sandy. Deposits increased by \$49.2 million at September 30, 2013, as compared to December 31, 2012.

Net income for the three months ended September 30, 2013 was stable at \$5.0 million, or \$0.29 per diluted share, as compared to net income of \$5.0 million, or \$0.28 per diluted share for the corresponding prior year period due to a reduction in the provision for loan losses offset by lower net interest income and lower other income. Diluted earnings per share for the three months ended September 30, 2013 benefitted from a reduction in shares outstanding.

Net interest income for the three months ended September 30, 2013 decreased to \$17.5 million, as compared to \$18.0 million in the same prior year period, reflecting a lower net interest margin partly offset by slightly higher interest-earning assets. The net interest margin decreased to 3.20% for the three months ended September 30, 2013, as compared to 3.28% for the corresponding prior year period and 3.21% reported in the linked prior quarter.

The provision for loan losses was \$700,000 for the three months ended September 30, 2013, as compared to \$1.4 million in the same prior year period due to reductions in net charge-offs and loans receivable, net. Additionally, non-performing loans decreased \$1.8 million, to \$41.6 million at September 30, 2013, from \$43.4 million at December 31, 2012.

Other income decreased to \$4.6 million for the three months ended September 30, 2013 as compared to \$4.9 million in the same prior year period. The net gain on sales of loans and the results from other real estate operations both declined while trust and asset management revenue, bankcard services revenue and fees and service charges improved. Operating expenses for the three months ended September 30, 2012 were adversely impacted by a non-recurring expense relating to the departure of the Bank's former President and Chief Operating Officer of \$747,000, net of related expense savings. Excluding the non-recurring severance expense, operating expenses increased \$692,000 due to staff additions for commercial lending and the Red Bank Financial Solutions Center, higher recruiting costs and lower deferred loan expense.

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The Company remains well-capitalized with a tangible common equity ratio of 9.35%.

Return on average stockholders' equity was 9.17% for the three months ended September 30, 2013, as compared to 9.08% for the corresponding prior year period.

**Analysis of Net Interest Income**

Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. Net interest income depends upon the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rate earned or paid on them.

The following table sets forth certain information relating to the Company for the three months and nine months ended September 30, 2013 and 2012. The yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown except where noted otherwise. Average balances are derived from average daily balances. The yields and costs include certain fees which are considered adjustments to yields.

|  | 2013                |               | AVERAGE<br>YIELD/<br>COST<br>(dollars in thousands) | 2012                |               | AVERAGE<br>YIELD/<br>COST |
|--|---------------------|---------------|---|---------------------|---------------|---------------------------|
|  | AVERAGE<br>BALANCE  | INTEREST      |   | AVERAGE<br>BALANCE  | INTEREST      |                           |
| <b>Assets</b>  |                     |               |   |                     |               |                           |
| Interest-earning assets:                             |                     |               |   |                     |               |                           |
| Interest-earning deposits and short-term Investments | \$ 46,311           | \$ 16         | 0.14%   | \$ 55,475           | \$ 15         | 0.11%                     |
| Securities (1)                                       | 613,929             | 2,394         | 1.56  | 574,453             | 2,586         | 1.80                      |
| FHLB stock   | 17,087              | 171           | 4.00  | 17,695              | 197           | 4.45                      |
| Loans receivable, net (2)                            | 1,519,002           | 17,403        | 4.58  | 1,547,696           | 18,716        | 4.84                      |
| <b>Total interest-earning assets</b>                 | <b>2,196,329</b>    | <b>19,984</b> | <b>3.64</b>   | <b>2,195,319</b>    | <b>21,514</b> | <b>3.92</b>               |
| Non-interest-earning assets                          | 115,016             |               |   | 116,227             |               |                           |
| <b>Total assets</b>                                  | <b>\$ 2,311,345</b> |               |   | <b>\$ 2,311,546</b> |               |                           |
| <b>Liabilities and Stockholders</b>                  |                     |               |   |                     |               |                           |
| <b>Equity</b>  |                     |               |   |                     |               |                           |
| Interest-bearing liabilities:                        |                     |               |   |                     |               |                           |
| Transaction deposits                                 | \$ 1,317,181        | 387           | 0.12  | \$ 1,317,658        | 971           | 0.29                      |
| Time deposits  | 211,584             | 720           | 1.36  | 238,133             | 936           | 1.57                      |
| <b>Total</b>   | <b>1,528,765</b>    | <b>1,107</b>  | <b>0.29</b>   | <b>1,555,791</b>    | <b>1,907</b>  | <b>0.49</b>               |
| Borrowed funds                                       | 329,281             | 1,333         | 1.62  | 335,231             | 1,607         | 1.92                      |

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|   |              |           |       |              |           |       |
|---|--------------|-----------|-------|--------------|-----------|-------|
| Total interest-bearing liabilities        | 1,858,046    | 2,440     | 0.53  | 1,891,022    | 3,514     | 0.74  |
| Non-interest-bearing deposits             | 219,723      |           |       | 183,780      |           |       |
| Non-interest-bearing liabilities          | 16,827       |           |       | 18,350       |           |       |
| Total liabilities                         | 2,094,596    |           |       | 2,093,152    |           |       |
| Stockholders equity                       | 216,749      |           |       | 218,394      |           |       |
| Total liabilities and stockholders equity | \$ 2,311,345 |           |       | \$ 2,311,546 |           |       |
| Net interest income                       |              | \$ 17,544 |       |              | \$ 18,000 |       |
| Net interest rate spread (3)              |              |           | 3.11% |              |           | 3.18% |
| Net interest margin (4)                   |              |           | 3.20% |              |           | 3.28% |

**FOR THE NINE MONTHS ENDED SEPTEMBER 30,**

2013

2012

|  | AVERAGE<br>BALANCE | INTEREST | AVERAGE<br>YIELD/<br>COST | AVERAGE<br>BALANCE | INTEREST | AVERAGE<br>YIELD/<br>COST |
|--|--------------------|----------|---------------------------|--------------------|----------|---------------------------|
|--|--------------------|----------|---------------------------|--------------------|----------|---------------------------|

(dollars in thousands)

|  |              |        |       |              |        |       |
|--|--------------|--------|-------|--------------|--------|-------|
| <b>Assets</b>  |              |        |       |              |        |       |
| Interest-earning assets:                             |              |        |       |              |        |       |
| Interest-earning deposits and short-term Investments |              |        |       |              |        |       |
|  | \$ 56,142    | \$ 61  | 0.14% | \$ 54,133    | \$ 58  | 0.14% |
| Securities (1)                                       | 598,098      | 7,108  | 1.58  | 552,661      | 8,100  | 1.95  |
| FHLB stock   | 17,113       | 534    | 4.16  | 17,749       | 626    | 4.70  |
| Loans receivable, net (2)                            | 1,514,693    | 52,493 | 4.62  | 1,555,556    | 57,642 | 4.94  |
| Total interest-earning assets                        | 2,186,046    | 60,196 | 3.67  | 2,180,099    | 66,426 | 4.06  |
| Non-interest-earning assets                          | 117,516      |        |       | 108,665      |        |       |
| Total assets   | \$ 2,303,562 |        |       | \$ 2,288,764 |        |       |
| <b>Liabilities and Stockholders Equity</b>           |              |        |       |              |        |       |
| Interest-bearing liabilities:                        |              |        |       |              |        |       |
| Transaction deposits                                 | \$ 1,322,095 | 1,389  | 0.14  | \$ 1,295,640 | 2,887  | 0.30  |
| Time deposits  | 216,198      | 2,218  | 1.37  | 247,704      | 3,073  | 1.65  |
| Total  | 1,538,293    | 3,607  | 0.31  | 1,543,344    | 5,960  | 0.51  |
| Borrowed funds                                       | 325,251      | 4,312  | 1.77  | 340,563      | 4,971  | 1.95  |
| Total interest-bearing liabilities                   | 1,863,544    | 7,919  | 0.57  | 1,883,907    | 10,931 | 0.77  |
| Non-interest-bearing deposits                        | 204,568      |        |       | 169,400      |        |       |



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|  |                     |                     |
|--|---------------------|---------------------|
| Non-interest-bearing liabilities                 | 16,463              | 16,935              |
| <b>Total liabilities</b>                         | <b>2,084,575</b>    | <b>2,070,242</b>    |
| Stockholders equity                              | 218,987             | 218,522             |
| <b>Total liabilities and stockholders equity</b> | <b>\$ 2,303,562</b> | <b>\$ 2,288,764</b> |
| Net interest income                              | \$ 52,277           | \$ 55,495           |
| <b>Net interest rate spread (3)</b>              | <b>3.10%</b>        | <b>3.29%</b>        |
| Net interest margin (4)                          | 3.19%               | 3.39%               |

- (1) Amounts are recorded at average amortized cost.
- (2) Amount is net of deferred loan fees, undisbursed loan funds, discounts and premiums and estimated loss allowances and includes loans held for sale and non-performing loans.
- (3) Net interest rate spread represents the difference between the yield on interest-earning assets and the cost of interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average interest-earning assets.

**Table of Contents****Comparison of Financial Condition at September 30, 2013 and December 31, 2012**

Total assets increased by \$17.1 million to \$2.286 billion at September 30, 2013, from \$2.269 billion at December 31, 2012. Cash and due from banks decreased \$18.5 million, to \$44.1 million, as compared to \$62.5 million at December 31, 2012. Securities, in the aggregate, increased by \$35.5 million, to \$583.0 million at September 30, 2013, as compared to \$547.5 million at December 31, 2012, as excess liquidity was invested. During the period, the Company reclassified \$536.0 million of securities available-for-sale to securities held-to-maturity as the Company has the intent and ability to hold these securities until maturity.

Loans receivable, net, decreased by \$775,000, to \$1.522 billion at September 30, 2013 from \$1.523 billion at December 31, 2012, primarily due to prepayments and sale of newly-originated 30-year fixed-rate one-to-four family loans. Commercial loans, however, grew \$29.9 million during this period and residential construction loans increased \$8.1 million as homeowners rebuild from superstorm Sandy.

Deposits increased by \$49.2 million, to \$1.769 billion at September 30, 2013, from \$1.720 billion at December 31, 2012 with core deposits, (i.e. all deposits excluding time deposits) growing by \$63.8 million. Securities sold under agreements to repurchase with retail customers increased by \$9.2 million, to \$70.0 million at September 30, 2013, from \$60.8 million at December 31, 2012. Federal Home Loan Bank ( FHLB ) advances decreased \$36.0 million, to \$189.0 million at September 30, 2013, from \$225.0 million at December 31, 2012.

Stockholders' equity decreased to \$213.8 million at September 30, 2013, as compared to \$219.8 million at December 31, 2012. Net income for the period was offset by an increase in accumulated other comprehensive loss of \$7.1 million caused by the rise in interest rates on the valuation of the then held-for-sale securities portfolio, the repurchase of 533,018 shares of common stock for \$8.1 million (average cost per share of \$15.21) and the cash dividends on common stock of \$6.2 million. At September 30, 2013, there were 301,766 shares remaining to be repurchased under the stock repurchase program adopted in the fourth quarter of 2012. Tangible stockholders' equity per common share increased to \$12.30 at September 30, 2013 as compared to \$12.28 at December 31, 2012, benefitting from the reduction in shares outstanding.

**Comparison of Operating Results for the Three and Nine months Ended September 30, 2013 and September 30, 2012***General*

Net income for the three and nine months ended September 30, 2013 was \$5.0 million and \$14.4 million, respectively, or \$0.29 per diluted share and \$0.84 per diluted share, respectively, as compared to net income of \$5.0 million and \$16.0 million, respectively, or \$0.28 per diluted share and \$0.89 per diluted share for the corresponding prior year periods. Net income for the three and nine months ended September 30, 2012 was adversely impacted by a non-recurring expense relating to the departure of the Bank's former President and Chief Operating Officer of \$747,000, net of related expense savings, or \$468,000 net of tax benefit. Net income was impacted in the current year periods by lower net interest income and lower other income, partly offset by a reduction in the provision for loan losses as compared to the prior year periods.

*Interest Income*

Interest income for the three and nine months ended September 30, 2013 was \$20.0 million and \$60.2 million, respectively, as compared to \$21.5 million and \$66.4 million for the three and nine months ended September 30, 2012. The yield on interest-earning assets declined to 3.64% and 3.67% for the three and nine months ended September 30,

2013, respectively, as compared to 3.92% and 4.06% for the same prior year periods. Average interest-earning assets increased by \$1.0 million and \$5.9 million for the three and nine months ended September 30, 2013, as compared to the same prior year periods. The increases in average interest-earning assets were primarily due to the increases in average securities which increased \$39.5 million and \$45.4 million, respectively, for the three and nine months ended September 30, 2013. These increases were partly offset by a decrease in average loans receivable, net, of \$28.7 million and \$40.9 million for the three and nine months ended September 30, 2013, as compared to the same prior year period.

*Interest Expense*

Interest expense for the three and nine months ended September 30, 2013 was \$2.4 million and \$7.9 million, respectively, as compared to \$3.5 million and \$10.9 million for the three and nine months ended September 30, 2012. The cost of interest-bearing liabilities decreased to 0.53% and 0.57%, respectively, for the three and nine months ended September 30, 2013 as compared to 0.74% and 0.77%, respectively, in the same prior year periods. Average interest-bearing liabilities decreased by \$33.0 million and \$20.4 million for the three and nine months ended September 30, 2013, as compared to the same prior year periods. The decreases were due to declines in average borrowed funds of \$6.0 million and \$15.3 million, respectively, and average time deposits of \$26.5 million and \$31.5 million, respectively, for the three and nine months ended September 30, 2013

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as compared to the same prior year periods. Additionally, for the nine months ended September 30, 2013, average transaction deposits were \$26.5 million higher than the prior year period. The growth in average interest-earning assets was partly funded by increases in average non-interest-bearing deposits of \$35.9 million and \$35.2 million, respectively, for the three and nine months ended September 30, 2013 as compared to same prior year periods.

*Net Interest Income*

Net interest income for the three and nine months ended September 30, 2013 decreased to \$17.5 million and \$52.3 million, respectively, as compared to \$18.0 million and \$55.5 million in the same prior year periods, reflecting a lower net interest margin partly offset by slightly higher interest-earning assets. The net interest margin decreased to 3.20% and 3.19%, respectively, for the three and nine months ended September 30, 2013, from 3.28% and 3.39% in the same prior year periods due to a change in the mix of average interest-earning assets from higher-yielding loans receivable into lower-yielding securities. High loan refinance volume earlier in the year also caused yields on loans and mortgage-backed securities to trend downward.

*Provision for Loan Losses*

For the three and nine months ended September 30, 2013, the provision for loan losses was \$700,000 and \$2.6 million, respectively, as compared to \$1.4 million and \$4.8 million, respectively, for the corresponding prior year periods. The decrease for the three and nine months ended September 30, 2013 was partly due to reductions of \$133,000 and \$2.5 million, respectively, in net charge-offs as compared to the same prior year periods and a reduction in loans receivable, net at September 30, 2013 as compared to both December 31, 2012 and September 30, 2012. Additionally, non-performing loans decreased \$1.8 million at September 30, 2013 as compared to December 31, 2012.

*Other Income*

For the three and nine months ended September 30, 2013, other income decreased to \$4.6 million and \$12.7 million as compared to \$4.9 million and \$13.7 million in the same prior year periods. The decrease in other income was primarily caused by the net gain on sales of loans decreasing by \$716,000 and \$1.7 million for the three and nine months ended September 30, 2013. Additionally, effective January 1, 2013, income from the origination of reverse mortgage loans is classified as part of fees and service charges as compared to inclusion in the net gain on the sale of loans in prior periods as the Bank no longer closes these loans in its name. The amount of reverse mortgage fees included in fees and service charges for the three and nine months ended September 30, 2013 was \$186,000 and \$531,000, respectively. For the three and nine months ended September 30, 2013, Bankcard services revenue increased \$91,000 and \$438,000, respectively, and trust and asset management revenue increased \$240,000 and \$492,000, respectively, as compared to the same prior year periods. The increase in trust and asset management revenue was partly due to an increase in assets under administration to \$212.0 million at September 30, 2013 from \$172.9 million at December 31, 2012. For the three and nine months ended September 30, 2013, the net gain on the sale of loans decreased to \$316,000 and \$877,000, respectively, as compared to \$1.2 million and \$3.1 million in the same prior year periods due to the reclassification of reverse mortgage income into fees and a decrease in loan sale volume which amounted to \$19.2 million and \$88.3 million, respectively, for the three and nine months ended September 30, 2013, as compared to \$45.1 million and \$127.7 million, respectively, for the same prior year periods. Additionally, the net gain on the sale of loans for the nine months ended September 30, 2013 was adversely impacted by an addition of \$975,000 to the reserve for repurchased loans as compared to an addition of \$350,000 in the same prior year period. For the three months ended September 30, 2013, there was no provision for repurchased loans as compared to \$100,000 in the same prior year period. The results from other real estate operations declined \$228,000 and \$55,000, respectively, for the three and nine months ended September 30, 2013, as compared to the same prior year periods. Finally, for the nine months ended September 30, 2013, the net gain on sales of investment securities

available for sale decreased to \$42,000 from \$226,000 in the same prior year period.

*Operating Expenses*

Operating expenses amounted to \$13.8 million and \$40.2 million, respectively, for the three and nine months ended September 30, 2013, as compared to \$13.8 million and \$39.6 million, respectively, in the same prior year periods. Excluding the \$747,000 non-recurring severance expense included in compensation and employee benefits, net of related expense savings, for the three and nine months ended September 30, 2012, operating expenses increased \$692,000 and \$1.3 million, respectively, as compared to the corresponding prior year periods. Compensation and employee benefits expense, net of the non-recurring severance cost, for the three and nine months ended September 30, 2013 was adversely impacted by staff additions for commercial lending and the Red Bank Financial Solutions Center, higher recruiting costs and by the decrease in mortgage loan closings from the prior year levels. Lower loan closings in the current periods decreased deferred loan expense, net of sales commissions to mortgage loan representatives, which is reflected as an increase in compensation expense.

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### *Provision for Income Taxes*

Income tax expense was \$2.7 million and \$7.8 million, respectively, for the three and nine months ended September 30, 2013, as compared to \$2.7 million and \$8.8 million for the same prior year periods. The effective tax rate was 34.9% and 35.2% for the three and nine months ended September 30, 2013 as compared to 35.1% and 35.5%, respectively, in the same prior year periods.

### **Liquidity and Capital Resources**

The Company's primary sources of funds are deposits, principal and interest payments on loans and mortgage-backed securities, proceeds from the sale of loans, FHLB and other borrowings and, to a lesser extent, investment maturities. While scheduled amortization of loans is a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by interest rates, economic conditions and competition. The Company has other sources of liquidity if a need for additional funds arises, including various lines of credit. During the quarter ended September 30, 2013, the Company transferred \$536.0 million of previously-designated available-for-sale securities to a held-to-maturity classification. The Company does not typically rely on the sale of securities as a source of liquidity and historically there have been no sales out of the types of securities transferred to held-to-maturity.

At September 30, 2013 and December 31, 2012, the Company had no overnight borrowings from the FHLB. The Company periodically utilizes overnight borrowings to fund short-term liquidity needs. The Company had total FHLB borrowings of \$189.0 million and \$225.0 million, respectively, at September 30, 2013 and December 31, 2012. Subsequent to quarter-end, the Company initiated a plan to restructure these borrowings and prepaid \$159.0 million of the outstanding advances at September 30, 2013, incurring a pre-tax prepayment fee of \$4.3 million. (Refer to Note 9. Subsequent Events.)

The Company's cash needs for the nine months ended September 30, 2013 were primarily satisfied by principal payments on loans and mortgage-backed securities, proceeds from the sale of mortgage loans held for sale, proceeds from maturities of investment securities and deposit growth. The cash was principally utilized for loan originations, the purchase of investment and mortgage-backed securities and to reduce FHLB borrowings. The Company's cash needs for the nine months ended September 30, 2012 were primarily satisfied by principal payments on loans and mortgage-backed securities, proceeds from the sale of mortgage loans held for sale, proceeds from maturities of investment securities and deposit growth. The cash was principally utilized for loan originations, the purchase of investment and mortgage-backed securities, the purchase of Bank owned life insurance and to reduce FHLB borrowings.

In the normal course of business, the Company routinely enters into various off-balance-sheet commitments, primarily relating to the origination and sale of loans. At September 30, 2013, outstanding commitments to originate loans totaled \$77.8 million; outstanding unused lines of credit totaled \$254.9 million; and outstanding commitments to sell loans totaled \$4.8 million. The Company expects to have sufficient funds available to meet current commitments arising in the normal course of business.

Time deposits scheduled to mature in one year or less totaled \$129.2 million at September 30, 2013. Based upon historical experience management estimates that a significant portion of such deposits will remain with the Company.

The Company has a detailed contingency funding plan and comprehensive reporting of funding trends on a monthly and quarterly basis which is reviewed by management. Management also monitors cash on a daily basis to determine the liquidity needs of the Bank. Additionally, management performs multiple liquidity stress test scenarios on a quarterly basis. The Bank continues to maintain significant liquidity under all stress scenarios.

Under the Company's stock repurchase program, shares of OceanFirst Financial Corp. common stock may be purchased in the open market and through other privately-negotiated transactions, from time-to-time, depending on market conditions. The repurchased shares are held as treasury stock for general corporate purposes. For the nine months ended September 30, 2013, the Company repurchased 533,018 shares of common stock at a total cost of \$8.1 million compared with repurchases of 718,253 shares at a cost of \$10.2 million for the nine months ended September 30, 2012. At September 30, 2013, there were 301,766 shares remaining to be repurchased under the existing stock repurchase program.

Cash dividends on common stock declared and paid during the first nine months of 2013 were \$6.2 million, as compared to \$6.5 million in the same prior year period. On October 16, 2013, the Board of Directors declared a quarterly cash dividend of twelve cents (\$0.12) per common share. The dividend is payable on November 8, 2013, to stockholders of record at the close of business on October 28, 2013.

The primary sources of liquidity specifically available to OceanFirst Financial Corp., the holding company of OceanFirst Bank, are capital distributions from the banking subsidiary and the issuance of preferred and common stock and long-term debt. For the nine months ended September 30, 2013, the Company received a dividend payment of \$12.0 million from the Bank. The Company's ability to continue to pay dividends will be largely dependent upon capital distributions from the Bank, which may be adversely affected by capital constraints imposed by the applicable regulations. The Company cannot predict whether the Bank will be permitted under applicable regulations to pay a dividend to the Company. If the Bank is unable to pay dividends to

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the Company, the Company may not have the liquidity necessary to pay a dividend in the future or pay a dividend at the same rate as historically paid, or be able to meet current debt obligations. At September 30, 2013, OceanFirst Financial Corp. held \$13.8 million in cash and \$8.5 million in investment securities available-for-sale.

As of September 30, 2013, the Bank exceeded all regulatory capital requirements as follows (in thousands):

|                           | Actual     |       | Required  |       |
|---------------------------|------------|-------|-----------|-------|
|                           | Amount     | Ratio | Amount    | Ratio |
| Tangible capital          | \$ 219,362 | 9.57% | \$ 34,396 | 1.50% |
| Core capital              | 219,362    | 9.57  | 91,723    | 4.00  |
| Tier 1 risk-based capital | 219,362    | 15.02 | 58,411    | 4.00  |
| Total risk-based capital  | 237,648    | 16.27 | 116,821   | 8.00  |

The Bank is considered a well-capitalized institution under the Prompt Corrective Action Regulations.

In July 2013 the Federal Deposit Insurance Corporation and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain available-for-sale securities holdings to be included for purposes of calculating regulatory capital unless a one-time opt-out is exercised. Additional constraints will also be imposed on the inclusion in regulatory capital of mortgage-servicing assets, deferred tax assets and minority interests. The rule limits a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule becomes effective for the Bank on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective.

At September 30, 2013, the Company maintained tangible common equity of \$213.8 million, for a tangible common equity to assets ratio of 9.35%.

**Off-Balance-Sheet Arrangements and Contractual Obligations**

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in the financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used for general corporate purposes or for customer needs. Corporate purpose transactions are used to help manage credit, interest rate and liquidity risk or to optimize capital. Customer transactions are used to manage customers' requests for funding. These financial instruments and commitments include unused lines of credit and commitments to extend credit. The Company also has outstanding commitments to sell loans amounting to \$4.8 million.

The following table shows the contractual obligations of the Company by expected payment period as of September 30, 2013 (in thousands):



| Contractual Obligation                     | Total      | Less than<br>one year | 1-3 years  | 3-5<br>years | More than<br>5 years |
|--|------------|-----------------------|------------|--------------|----------------------|
| Debt Obligations                           | \$ 286,451 | \$ 124,951            | \$ 114,000 | \$ 25,000    | \$ 22,500            |
| Commitments to Originate Loans             | 77,802     | 77,802                |            |              |                      |
| Commitments to Fund Unused Lines of Credit | 254,872    | 254,872               |            |              |                      |

Commitments to originate loans and commitments to fund unused lines of credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company's exposure to credit risk is represented by the contractual amount of the instruments.

**Table of Contents****Non-Performing Assets**

The following table sets forth information regarding the Company's non-performing assets consisting of non-performing loans and Other Real Estate Owned ( OREO ). It is the policy of the Company to cease accruing interest on loans 90 days or more past due or in the process of foreclosure.

|                                    | September 30,<br>2013  | December 31,<br>2012 |
|------------------------------------|------------------------|----------------------|
|                                    | (dollars in thousands) |                      |
| <b>Non-performing loans:</b>       |                        |                      |
| Real estate one-to-four family     | \$ 28,970              | \$ 26,521            |
| Commercial real estate             | 7,398                  | 11,567               |
| Consumer                           | 4,428                  | 4,540                |
| Commercial                         | 769                    | 746                  |
| <b>Total non-performing loans</b>  | <b>41,565</b>          | <b>43,374</b>        |
| <b>OREO, net</b>                   | <b>4,259</b>           | <b>3,210</b>         |
| <b>Total non-performing assets</b> | <b>\$ 45,824</b>       | <b>\$ 46,584</b>     |
| <b>Delinquent loans 30-89 days</b> | <b>\$ 18,965(1)(2)</b> | <b>\$ 11,437(1)</b>  |

- (1) Delinquent loans 30-89 days at December 31, 2012, excludes \$16.5 million of loans impacted by superstorm Sandy for which the Bank had granted a temporary payment plan. Delinquent loans 30-89 days at September 30, 2013 includes \$475,000 of loans impacted by superstorm Sandy.
- (2) The increase in delinquent loans 30-89 days at September 30, 2013 is primarily due to one commercial real estate loan relationship with an outstanding balance of \$6.2 million which is 60 days delinquent. The loan is secured by multiple real estate parcels recently appraised at \$8.3 million and by personal guarantees.

|  |       |       |
|--|-------|-------|
| Allowance for loan losses as a percent of total loans receivable     | 1.35% | 1.32% |
| Allowance for loan losses as a percent of total non-performing loans | 50.25 | 47.29 |
| Non-performing loans as a percent of total loans receivable          | 2.68  | 2.80  |
| Non-performing assets as a percent of total assets                   | 2.00  | 2.05  |

The Company's non-performing loans decreased \$1.8 million at September 30, 2013, as compared to December 31, 2012. Included in non-performing loans at September 30, 2013 were \$2.7 million in loans which remain adversely impacted by superstorm Sandy which caused substantial disruption in the Bank's market area on October 29, 2012. The Bank increased its allowance for loan losses at December 31, 2012 by \$1.8 million in expectation of potential losses from increasing levels of non-performing loans for borrowers impacted by superstorm Sandy.

Included in the non-performing loan total at September 30, 2013 was \$11.9 million of troubled debt restructured loans, as compared to \$18.2 million of troubled debt restructured loans at December 31, 2012. Non-performing loans are concentrated in one-to-four family loans, which comprise 70.0% of the total at September 30, 2013. At

September 30, 2013, the average weighted loan-to-value ratio of non-performing one-to-four family loans, after any related charge-offs, was 59% using appraisal values at time of origination and 77% using updated appraisal values. Appraisals are updated for all non-performing residential loans secured by real estate and subsequently updated annually if the loan remains delinquent for an extended period. At September 30, 2013, the average weighted loan-to-value ratio of the total one-to-four family loan portfolio was 56% using appraisal values at time of origination. The Company's non-performing loans remain at elevated levels partly due to the extended foreclosure process in the State of New Jersey and the lingering impact of superstorm Sandy. The protracted foreclosure process delays the Company's ability to resolve non-performing loans through the sale of the underlying collateral.

The largest non-performing loan is a commercial real estate loan to a self-storage facility with a balance of \$2.1 million. In September 2011, the Company entered into a troubled debt restructuring with the borrower which reduced the interest rate and extended the payment term. All scheduled payments under the restructured terms have been made since that date but the loan has remained on non-accrual due to continued uncertainty about the borrower's ability to service the debt.

The Company classifies loans and other assets in accordance with regulatory guidelines as follows (in thousands):

|   | September 30,<br>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
| Loans and other assets excluding investment securities: |                       |                      |
| Special Mention   | \$ 7,443              | \$ 6,245             |
| Substandard   | 68,941                | 65,039               |
| Doubtful  | 881                   | 1,081                |
| Investment securities:                                  |                       |                      |
| Substandard   |                       | 25,000               |

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The largest Special Mention loan relationship at September 30, 2013 consists of two commercial business loans to an importer and contractor for \$3.4 million which was current as to payments. The borrower is ceasing operations due to economic factors and operating difficulties. Subsequent to quarter-end, the borrower and its principals repaid \$2.5 million. The liquidation of corporate assets is expected to satisfy the remaining principal in full. The largest Substandard loan relationship consists of several credits to a single borrower operating a marina, with an aggregate balance of \$6.8 million. The loans are criticized due to weak, but improving, operating results. The loans are collateralized by commercial and residential real estate, all business assets and also carry a personal guarantee. In November 2011, the Company entered into a troubled debt restructuring with the borrower which reduced the interest rate in exchange for additional collateral. The loan was renewed in December 2012 at comparable terms. The borrower is current as to payments under the restructured terms and the loans were therefore returned to accrual status as of September 2013, although the Substandard classification was retained. The largest Doubtful asset is a portion of the commercial real estate loan to a self-storage facility, as described above, with a balance of \$879,000. In addition to loan classifications, the Company previously classified select investment securities as Substandard, representing the amount with a credit rating below investment grade from one of the internationally-recognized credit rating services. These securities have consistently remained current as to principal and interest payments. During the first quarter of 2013, the Company performed, with the assistance of an independent expert, a detailed analysis relating to the collectability of these securities. The analysis concluded that the issuers of these securities have an adequate capacity to meet financial commitments as originally agreed for the projected life of the security, the risk of default is low and the full and timely repayment of principal and interest is expected.

**Critical Accounting Policies**

Note 1 to the Company's Audited Consolidated Financial Statements for the year ended December 31, 2012 included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 (the 2012 Form 10-K), as supplemented by this report, contains a summary of significant accounting policies. Various elements of these accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. Certain assets are carried in the consolidated statements of financial condition at fair value or the lower of cost or fair value. Policies with respect to the methodologies used to determine the allowance for loan losses, the reserve for repurchased loans and the valuation of Mortgage Servicing Rights and judgments regarding securities impairment are the most critical accounting policies because they are important to the presentation of the Company's financial condition and results of operations. These judgments and policies involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. The use of different judgments, assumptions and estimates could result in material differences in the results of operations or financial condition. These critical accounting policies and their application are reviewed periodically and, at least annually, with the Audit Committee of the Board of Directors.

**Private Securities Litigation Reform Act Safe Harbor Statement**

In addition to historical information, this quarterly report contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 which are based on certain assumptions and describe future plans, strategies and expectations of the Company. These forward-looking statements are generally identified by use of the words believe, expect, intend, anticipate, estimate, project, will, should, may, view, potential, or similar expressions or expressions of confidence. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, general economic conditions, levels of unemployment in the Bank's lending area, real estate market values in the Bank's lending area, the level of prepayments on loans and mortgage-backed securities, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government including policies of the U.S. Treasury and the Board of

Governors of the Federal Reserve System, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area and accounting principles and guidelines. These risks and uncertainties are further discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 and subsequent securities filings and should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. The Company does not undertake - and specifically disclaims any obligation - to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Further description of the risks and uncertainties to the business are included in Item 1, Business and Item 1A, Risk Factors of the Company's 2012 Form 10-K and Item 1A of this Form 10-Q.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company's interest rate sensitivity is monitored through the use of an interest rate risk ( IRR ) model. The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at September 30, 2013, which were anticipated by the Company, based upon certain assumptions, to reprice or mature in each of the future time periods shown.

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At September 30, 2013, the Company's one-year gap was negative 3.49% as compared to positive 0.90% at December 31, 2012. The change from December 31, 2012 was due to the investment of excess short-term liquidity and an expected slowdown in prepayments from loans and mortgage-backed securities.

| At September 30, 2013<br>(dollars in thousands)  | 3 Months<br>or Less | More than<br>3 Months to<br>1 Year | More than<br>1 Year to<br>3 Years | More than<br>3 Years<br>to<br>5 Years | More than<br>5 Years | Total             |
|--|---------------------|------------------------------------|-----------------------------------|---------------------------------------|----------------------|-------------------|
| <b>Interest-earning assets: (1)</b>  |                     |                                    |                                   |                                       |                      |                   |
| Interest-earning deposits and short-term investments                                     | \$ 10,880           | \$                                 | \$                                | \$                                    | \$                   | \$ 10,880         |
| Investment securities  | 81,755              | 30,854                             | 92,145                            | 14,879                                | 8,628                | 228,261           |
| Mortgage-backed securities   | 51,540              | 35,745                             | 87,864                            | 78,049                                | 113,417              | 366,615           |
| FHLB stock   |                     |                                    |                                   |                                       | 15,211               | 15,211            |
| Loans receivable (2)   | 322,330             | 368,530                            | 406,937                           | 197,721                               | 246,510              | 1,542,028         |
| <b>Total interest-earning assets</b>   | <b>466,505</b>      | <b>435,129</b>                     | <b>586,946</b>                    | <b>290,649</b>                        | <b>383,766</b>       | <b>2,162,995</b>  |
| <b>Interest-bearing liabilities:</b>   |                     |                                    |                                   |                                       |                      |                   |
| Money market deposit accounts  | 24,173              | 9,700                              | 21,379                            | 16,178                                | 52,920               | 124,350           |
| Savings accounts   | 63,563              | 22,570                             | 49,835                            | 37,720                                | 117,443              | 291,131           |
| Interest-bearing checking accounts   | 521,210             | 59,245                             | 110,321                           | 90,280                                | 143,638              | 924,694           |
| Time deposits  | 46,125              | 83,071                             | 45,224                            | 31,193                                | 6,065                | 211,678           |
| FHLB advances  | 5,000               | 50,000                             | 109,000                           | 25,000                                |                      | 189,000           |
| Securities sold under agreements to repurchase   | 69,951              |                                    |                                   |                                       |                      | 69,951            |
| Other borrowings   | 22,500              |                                    | 5,000                             |                                       |                      | 27,500            |
| <b>Total interest-bearing liabilities</b>  | <b>752,522</b>      | <b>224,586</b>                     | <b>340,759</b>                    | <b>200,371</b>                        | <b>320,066</b>       | <b>1,838,304</b>  |
| <b>Interest sensitivity gap (3)</b>  | <b>\$ (286,017)</b> | <b>\$ 210,543</b>                  | <b>\$ 246,187</b>                 | <b>\$ 90,278</b>                      | <b>\$ 63,700</b>     | <b>\$ 324,691</b> |
| <b>Cumulative interest sensitivity gap</b>   | <b>\$ (286,017)</b> | <b>\$ (75,474)</b>                 | <b>\$ 170,713</b>                 | <b>\$ 260,991</b>                     | <b>\$ 324,691</b>    | <b>\$ 324,691</b> |
| <b>Cumulative interest sensitivity gap as a percent of total interest-earning assets</b> | <b>(13.22)%</b>     | <b>(3.49)%</b>                     | <b>7.89%</b>                      | <b>12.07%</b>                         | <b>15.01%</b>        | <b>15.01%</b>     |

(1)

Interest-earning assets are included in the period in which the balances are expected to be redeployed and/or repriced as a result of anticipated prepayments, scheduled rate adjustments, and contractual maturities.

(2) For purposes of the gap analysis, loans receivable includes loans held for sale and non-performing loans gross of the allowance for loan losses, unamortized discounts and deferred loan fees.

(3) Interest sensitivity gap represents the difference between interest-earning assets and interest-bearing liabilities.

Additionally, the table below sets forth the Company's exposure to interest rate risk as measured by the change in net portfolio value ( NPV ) and net interest income under varying rate shocks as of September 30, 2013 and December 31, 2012. All methods used to measure interest rate sensitivity involve the use of assumptions, which may tend to oversimplify the manner in which actual yields and costs respond to changes in market interest rates. The Company's interest rate sensitivity should be reviewed in conjunction with the financial statements and notes thereto contained in the 2012 Form 10-K.

| Change in Interest Rates in<br>Basis Points (Rate Shock)<br>dollars in thousands) | September 30, 2013     |             |                     |           |             | December 31, 2012      |             |                     |           |             |
|---|------------------------|-------------|---------------------|-----------|-------------|------------------------|-------------|---------------------|-----------|-------------|
|   | Net Portfolio<br>Value |             | Net Interest Income |           |             | Net Portfolio<br>Value |             | Net Interest Income |           |             |
|   | Amount                 | %<br>Change | NPV<br>Ratio        | Amount    | %<br>Change | Amount                 | %<br>Change | NPV<br>Ratio        | Amount    | %<br>Change |
| 300   | \$ 247,953             | (12.1)%     | 11.5%               | \$ 65,447 | (5.4)%      | \$ 248,847             | (2.0)%      | 11.5%               | \$ 64,291 | (4.3)%      |
| 200   | 263,348                | (6.7)       | 12.0                | 67,447    | (2.5)       | 260,055                | 2.4         | 11.7                | 66,484    | (1.0)       |
| 100   | 275,530                | (2.3)       | 12.2                | 68,518    | (0.9)       | 263,429                | 3.7         | 11.6                | 67,311    | 0.2         |
| Static  | 282,140                |             | 12.2                | 69,170    |             | 254,020                |             | 11.0                | 67,163    |             |
| (100)   | 276,052                | (2.2)       | 11.8                | 65,594    | (5.2)       | 206,602                | (18.7)      | 8.8                 | 62,877    | (6.4)       |

#### Item 4. Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the Exchange Act). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective. Disclosure controls and procedures are the controls and other procedures that are designed to ensure that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (SEC) (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. In addition, based on that evaluation, there were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****OceanFirst Financial Corp.****Consolidated Statements of Financial Condition**

(dollars in thousands, except per share amounts)

|  | September 30,<br>2013<br>(Unaudited) | December 31,<br>2012 |
|--|--------------------------------------|----------------------|
| <b>Assets</b>  |                                      |                      |
| Cash and due from banks  | \$ 44,055                            | \$ 62,544            |
| Securities available-for-sale, at estimated fair value   | 68,968                               | 547,450              |
| Securities held-to-maturity, net (estimated fair value of 517,173 at September 30, 2013)   | 514,022                              |                      |
| Federal Home Loan Bank of New York stock, at cost  | 15,211                               | 17,061               |
| Loans receivable, net  | 1,522,425                            | 1,523,200            |
| Mortgage loans held for sale   | 2,566                                | 6,746                |
| Interest and dividends receivable  | 6,087                                | 5,976                |
| Other real estate owned, net   | 4,259                                | 3,210                |
| Premises and equipment, net  | 22,641                               | 22,233               |
| Servicing asset  | 4,314                                | 4,568                |
| Bank Owned Life Insurance  | 54,233                               | 53,167               |
| Other assets   | 27,507                               | 23,073               |
| <b>Total assets</b>  | <b>\$ 2,286,288</b>                  | <b>\$ 2,269,228</b>  |
| <b>Liabilities and Stockholders Equity</b>   |                                      |                      |
| Deposits   | \$ 1,768,914                         | \$ 1,719,671         |
| Securities sold under agreements to repurchase with retail customers   | 69,951                               | 60,791               |
| Federal Home Loan Bank advances  | 189,000                              | 225,000              |
| Other borrowings   | 27,500                               | 27,500               |
| Advances by borrowers for taxes and insurance  | 8,230                                | 7,386                |
| Other liabilities  | 8,924                                | 9,088                |
| <b>Total liabilities</b>   | <b>2,072,519</b>                     | <b>2,049,436</b>     |
| <b>Stockholders equity:</b>  |                                      |                      |
| Preferred stock, \$.01 par value, \$1,000 liquidation preference, 5,000,000 shares authorized, no shares issued  |                                      |                      |
| Common stock, \$.01 par value, 55,000,000 shares authorized, 33,566,772 shares issued and 17,386,060 and 17,894,929 shares outstanding at September 30, 2013 and December 31, 2012, respectively | 336                                  | 336                  |
| Additional paid-in capital   | 263,125                              | 262,704              |
| Retained earnings  | 206,291                              | 198,109              |
| Accumulated other comprehensive (loss) gain  | (7,011)                              | 49                   |
| Less: Unallocated common stock held by Employee Stock Ownership Plan   | (3,688)                              | (3,904)              |



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|  |                |                |
|--|----------------|----------------|
| Treasury stock, 16,180,712 and 15,671,843 shares at September 30, 2013 and December 31, 2012, respectively | (245,284)      | (237,502)      |
| Common stock acquired by Deferred Compensation Plan  | (660)          | (647)          |
| Deferred Compensation Plan Liability   | 660            | 647            |
| <b>Total stockholders' equity</b>  | <b>213,769</b> | <b>219,792</b> |
| Total liabilities and stockholders' equity   | \$ 2,286,288   | \$ 2,269,228   |

See accompanying Notes to Unaudited Consolidated Financial Statements.

**Table of Contents****OceanFirst Financial Corp.****CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share amounts)

|   | For the three months<br>ended<br>September 30,<br>2013      2012<br>(Unaudited) |               | For the nine months<br>ended<br>September 30,<br>2013      2012<br>(Unaudited) |               |
|---|---|---------------|--|---------------|
| <b>Interest income:</b>                                       |   |               |  |               |
| Loans   | \$ 17,403   | \$ 18,716     | \$ 52,493  | \$ 57,642     |
| Mortgage-backed securities                                    | 1,865   | 2,065         | 5,540  | 6,618         |
| Investment securities and other                               | 716   | 733           | 2,163  | 2,166         |
| <b>Total interest income</b>                                  | <b>19,984</b>   | <b>21,514</b> | <b>60,196</b>  | <b>66,426</b> |
| <b>Interest expense:</b>                                      |   |               |  |               |
| Deposits  | 1,107   | 1,907         | 3,607  | 5,960         |
| Borrowed funds  | 1,333   | 1,607         | 4,312  | 4,971         |
| <b>Total interest expense</b>                                 | <b>2,440</b>  | <b>3,514</b>  | <b>7,919</b>   | <b>10,931</b> |
| Net interest income   | 17,544  | 18,000        | 52,277   | 55,495        |
| Provision for loan losses                                     | 700   | 1,400         | 2,600  | 4,800         |
| Net interest income after provision for loan losses           | 16,844  | 16,600        | 49,677   | 50,695        |
| <b>Other income:</b>  |   |               |  |               |
| Bankcard services revenue                                     | 943   | 852           | 2,675  | 2,237         |
| Trust and asset management revenue                            | 628   | 388           | 1,583  | 1,091         |
| Fees and service charges                                      | 2,247   | 1,873         | 6,037  | 5,710         |
| Loan servicing income   | 200   | 130           | 528  | 409           |
| Net gain on sales of investment securities available-for-sale |   |               | 42   | 226           |
| Net gain on sales of loans available-for-sale                 | 316   | 1,218         | 877  | 3,136         |
| Net (loss) gain from other real estate operations             | (188)   | 40            | (112)  | (57)          |
| Income from Bank Owned Life Insurance                         | 419   | 376           | 1,067  | 977           |
| Other   | 1   | 1             | 20   | 5             |
| <b>Total other income</b>                                     | <b>4,566</b>  | <b>4,878</b>  | <b>12,717</b>  | <b>13,734</b> |
| <b>Operating expenses:</b>                                    |   |               |  |               |
| Compensation and employee benefits                            | 7,397   | 7,347         | 21,014   | 20,978        |
| Occupancy   | 1,364   | 1,279         | 4,104  | 3,897         |
| Equipment   | 675   | 662           | 2,003  | 1,892         |

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|  |          |          |           |           |
|--|----------|----------|-----------|-----------|
| Marketing                                | 444      | 451      | 1,142     | 1,231     |
| Federal deposit insurance                | 538      | 533      | 1,598     | 1,587     |
| Data processing                          | 1,067    | 914      | 3,002     | 2,738     |
| Check card processing                    | 454      | 425      | 1,288     | 1,061     |
| Professional fees                        | 358      | 731      | 1,673     | 1,909     |
| Other operating expense                  | 1,487    | 1,497    | 4,350     | 4,353     |
| Total operating expenses                 | 13,784   | 13,839   | 40,174    | 39,646    |
| Income before provision for income taxes | 7,626    | 7,639    | 22,220    | 24,783    |
| Provision for income taxes               | 2,658    | 2,680    | 7,828     | 8,804     |
| Net income                               | \$ 4,968 | \$ 4,959 | \$ 14,392 | \$ 15,979 |
| Basic earnings per share                 | \$ 0.29  | \$ 0.28  | \$ 0.84   | \$ 0.90   |
| Diluted earnings per share               | \$ 0.29  | \$ 0.28  | \$ 0.84   | \$ 0.89   |
| Average basic shares outstanding         | 17,047   | 17,561   | 17,145    | 17,837    |
| Average diluted shares outstanding       | 17,210   | 17,621   | 17,194    | 17,896    |

See accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents**OceanFirst Financial Corp.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands)

|   | For the three<br>months<br>ended September 30, |          | For the nine months<br>ended September 30, |           |
|---|--|----------|--|-----------|
|   | 2013   | 2012     | 2013                                       | 2012      |
|   | (Unaudited)                                    |          | (Unaudited)                                |           |
| Net income  | \$ 4,968                                       | \$ 4,959 | \$ 14,392                                  | \$ 15,979 |
| Other comprehensive income:   |  |          |  |           |
| Unrealized (loss) gain on securities (net of tax benefit of \$1,498 and \$4,859 in 2013 and tax expense of \$695 and \$2,041 in 2012) | (2,169)  | 1,006    | (7,035)                                    | 2,956     |
| Reclassification adjustment for gains included in net income (net of tax expense of \$17 in 2013 and \$92 in 2012)                    |  |          | (25)                                       | (134)     |
| Total comprehensive income  | \$ 2,799                                       | \$ 5,965 | \$ 7,332                                   | \$ 18,801 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents**OceanFirst Financial Corp.****Consolidated Statements of****Changes in Stockholders Equity (Unaudited)**

(in thousands, except per share amounts)

|   | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Gain<br>(Loss) | Employee<br>Ownership<br>Plan | Treasury<br>Stock | Common<br>Stock<br>Acquired<br>by<br>Deferred<br>Compensation<br>Plan | Liability  | Total |
|---|--------------------|-----------------|----------------------------------|----------------------|---|-------------------------------|-------------------|---|------------|-------|
| Balance at December 31, 2011                                  | \$ 336             | \$ 262,812      | \$ 186,666                       | \$ (2,468)           | \$ (4,193)  | \$ (226,304)                  | \$ (871)          | \$ 871  | \$ 216,849 |       |
| Net income  |                    |                 | 15,979                           |                      |   |                               |                   |   | 15,979     |       |
| Unrealized gain on securities<br>(net of tax expense \$1,949) |                    |                 |                                  |                      | 2,822   |                               |                   |   | 2,822      |       |
| Tax expense of stock plans                                    |                    |                 | (482)                            |                      |   |                               |                   |   | (482)      |       |
| Stock awards  |                    |                 | 396                              |                      |   |                               |                   |   | 396        |       |
| Treasury stock allocated to<br>restricted stock plan          |                    |                 | (282)                            | 42                   |   |                               | 240               |   |            |       |
| Purchased 718,253 shares of<br>common stock                   |                    |                 |                                  |                      |   |                               | (10,196)          |   | (10,196)   |       |
| Allocation of ESOP stock                                      |                    |                 | 146                              |                      |   | 217                           |                   |   | 363        |       |
| Cash dividend \$0.36 per share                                |                    |                 |                                  | (6,463)              |   |                               |                   |   | (6,463)    |       |
| Exercise of stock options                                     |                    |                 |                                  | (40)                 |   |                               | 459               |   | 419        |       |
| Sale of stock for the deferred<br>compensation plan           |                    |                 |                                  |                      |   |                               |                   | 182   | (182)      |       |
| Balance at September 30,<br>2012                              | \$ 336             | \$ 262,590      | \$ 196,184                       | \$ 354               | \$ (3,976)  | \$ (235,801)                  | \$ (689)          | \$ 689  | \$ 219,687 |       |
| Balance at December 31, 2012                                  | \$ 336             | \$ 262,704      | \$ 198,109                       | \$ 49                | \$ (3,904)  | \$ (237,502)                  | \$ (647)          | \$ 647  | \$ 219,792 |       |
| Net income  |                    |                 | 14,392                           |                      |   |                               |                   |   | 14,392     |       |
| Unrealized loss on securities<br>(net of tax benefit \$4,876) |                    |                 |                                  |                      | (7,060)   |                               |                   |   | (7,060)    |       |
| Stock awards  |                    |                 | 509                              |                      |   |                               |                   |   | 509        |       |
| Treasury stock allocated to<br>restricted stock plan          |                    |                 | (259)                            | 4                    |   |                               | 255               |   |            |       |
| Purchased 533,018 shares of<br>common stock                   |                    |                 |                                  |                      |   |                               | (8,107)           |   | (8,107)    |       |
| Allocation of ESOP stock                                      |                    |                 | 171                              |                      |   | 216                           |                   |   | 387        |       |
| Cash dividend \$0.36 per share                                |                    |                 |                                  | (6,208)              |   |                               |                   |   | (6,208)    |       |
| Exercise of stock options                                     |                    |                 |                                  | (6)                  |   |                               | 70                |   | 64         |       |

|  |  |  |  |  |  |  |  |      |    |
|--|--|--|--|--|--|--|--|------|----|
| Purchase of stock for the deferred compensation plan |  |  |  |  |  |  |  | (13) | 13 |
|--|--|--|--|--|--|--|--|------|----|

|                               |    |        |            |            |            |            |              |          |        |            |
|-------------------------------|----|--------|------------|------------|------------|------------|--------------|----------|--------|------------|
| Balance at September 30, 2013 | \$ | \$ 336 | \$ 263,125 | \$ 206,291 | \$ (7,011) | \$ (3,688) | \$ (245,284) | \$ (660) | \$ 660 | \$ 213,769 |
|-------------------------------|----|--------|------------|------------|------------|------------|--------------|----------|--------|------------|

See accompanying Notes to Unaudited Consolidated Financial Statements.

**Table of Contents****OceanFirst Financial Corp.****Consolidated Statements of Cash Flows**

(dollars in thousands)

|  | For the nine months<br>ended September 30, |               |
|--|--|---------------|
|  | 2013                                       | 2012          |
|  | (Unaudited)                                |               |
| <b>Cash flows from operating activities:</b>   |  |               |
| Net income   | \$ 14,392                                  | \$ 15,979     |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |  |               |
| Depreciation and amortization of premises and equipment                                  | 2,131                                      | 1,953         |
| Allocation of ESOP stock   | 387  | 363           |
| Stock awards   | 509  | 396           |
| Amortization of servicing asset  | 1,075                                      | 1,225         |
| Net premium amortization in excess of discount accretion on securities                   | 2,861                                      | 2,525         |
| Net amortization of deferred costs and discounts on loans                                | 440  | 650           |
| Provision for loan losses  | 2,600                                      | 4,800         |
| Provision for repurchased loans and loss sharing obligations                             | 975  | 350           |
| Net gain on sale of other real estate owned  | (35)                                       | (151)         |
| Net gain on sales of investment securities available-for-sale                            | (42)                                       | (226)         |
| Net gain on sales of loans   | (1,852)                                    | (3,486)       |
| Proceeds from sales of mortgage loans held for sale                                      | 88,383                                     | 135,426       |
| Mortgage loans originated for sale   | (83,173)                                   | (129,288)     |
| Purchase of Bank Owned Life Insurance  |  | (10,000)      |
| Proceeds from Bank Owned Life Insurance  |  | 158           |
| Increase in value of Bank Owned Life Insurance   | (1,067)                                    | (977)         |
| Increase in interest and dividends receivable  | (111)                                      | (531)         |
| Decrease in other assets   | 443  | 2,482         |
| (Decrease) increase in other liabilities   | (1,139)                                    | 3,853         |
| <b>Total adjustments</b>   | <b>12,385</b>                              | <b>9,522</b>  |
| <b>Net cash provided by operating activities</b>   | <b>26,777</b>                              | <b>25,501</b> |
| <b>Cash flows from investing activities:</b>   |  |               |
| Net (increase) decrease in loans receivable  | (5,193)                                    | 8,517         |
| Purchase of investment securities available-for-sale                                     | (28,292)                                   | (64,324)      |
| Purchase of mortgage-backed securities available-for-sale                                | (127,582)                                  | (88,263)      |
| Purchase of investment securities held-to-maturity                                       | (246)                                      |               |
| Proceeds from maturities of investment securities available-for-sale                     | 20,396                                     | 22,336        |
| Proceeds from maturities of investment securities held-to-maturity                       | 1,970                                      |               |
| Proceeds from sale of investment securities available-for-sale                           | 603  | 1,221         |

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|   |          |          |
|---|----------|----------|
| Principal repayments on mortgage-backed securities available-for-sale | 75,495   | 89,460   |
| Principal repayments on mortgage-backed securities held-to-maturity   | 7,362    |          |
| Decrease in Federal Home Loan Bank of New York stock                  | 1,850    | 1,012    |
| Proceeds from sales of other real estate owned                        | 1,914    | 1,905    |
| Purchases of premises and equipment                                   | (2,539)  | (1,927)  |
| Net cash used in investing activities                                 | (54,262) | (30,063) |

Continued



**Table of Contents****OceanFirst Financial Corp.****Consolidated Statements of Cash Flows (Continued)**

(dollars in thousands)

|   | For the nine months<br>ended September 30, |                 |
|---|--|-----------------|
|   | 2013                                       | 2012            |
|   | (Unaudited)                                |                 |
| <b>Cash flows from financing activities:</b>                          |  |                 |
| Increase in deposits  | \$ 49,243                                  | \$ 33,891       |
| Increase in short-term borrowings                                     | 9,160                                      | 6,048           |
| Proceeds from Federal Home Loan Bank advances                         | 25,000                                     |                 |
| Repayments of Federal Home Loan Bank advances                         | (61,000)                                   | (41,000)        |
| Increase in advances by borrowers for taxes and insurance             | 844  | 183             |
| Exercise of stock options   | 64   | 419             |
| Purchase of treasury stock  | (8,107)                                    | (10,196)        |
| Dividends paid  | (6,208)                                    | (6,463)         |
| Tax expense of stock plans  |  | (482)           |
| <b>Net cash provided by (used in) financing activities</b>            | <b>8,996</b>                               | <b>(17,600)</b> |
| <br>  |  |                 |
| Net decrease in cash and due from banks                               | (18,489)                                   | (22,162)        |
| Cash and due from banks at beginning of period                        | 62,544                                     | 77,527          |
| <br>  |  |                 |
| Cash and due from banks at end of period                              | \$ 44,055                                  | \$ 55,365       |
| <br>  |  |                 |
| <b>Supplemental Disclosure of Cash Flow Information:</b>              |  |                 |
| Cash paid during the period for:                                      |  |                 |
| Interest  | \$ 8,008                                   | \$ 11,000       |
| Income taxes  | 6,793                                      | 6,118           |
| Non-cash activities:  |  |                 |
| Reclassification of securities available-for-sale to held-to-maturity | 536,010                                    |                 |
| Loans charged-off, net  | 2,223                                      | 4,739           |
| Transfer of loans receivable to other real estate owned               | 2,928                                      | 3,412           |

See accompanying Notes to Unaudited Consolidated Financial Statements.

**Table of Contents****OceanFirst Financial Corp.****Notes To Unaudited Consolidated Financial Statements****Note 1. Basis of Presentation**

The accompanying unaudited consolidated financial statements include the accounts of OceanFirst Financial Corp. (the Company) and its wholly-owned subsidiary, OceanFirst Bank (the Bank), and its wholly-owned subsidiaries, Columbia Home Loans, LLC (Columbia), OceanFirst REIT Holdings, Inc., OceanFirst Services, LLC and 975 Holdings, LLC. The operations of Columbia were shuttered in late 2007.

The interim consolidated financial statements reflect all normal and recurring adjustments which are, in the opinion of management, considered necessary for a fair presentation of the financial condition and results of operations for the periods presented. The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results of operations that may be expected for all of 2013. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the statements of financial condition and the results of operations for the period. Actual results could differ from these estimates.

Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC).

These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report to Stockholders on Form 10-K for the year ended December 31, 2012.

**Note 2. Earnings per Share**

The following reconciles shares outstanding for basic and diluted earnings per share for the three and nine months ended September 30, 2013 and 2012 (in thousands):

|  | Three months ended |        | Nine months ended |        |
|--|--------------------|--------|-------------------|--------|
|  | September 30,      |        | September 30,     |        |
|  | 2013               | 2012   | 2013              | 2012   |
| Weighted average shares issued net of Treasury shares                            | 17,590             | 18,130 | 17,689            | 18,415 |
| Less: Unallocated ESOP shares  | (442)              | (476)  | (450)             | (484)  |
| Unallocated incentive award shares and shares held by deferred compensation plan | (101)              | (93)   | (94)              | (94)   |
| Average basic shares outstanding   | 17,047             | 17,561 | 17,145            | 17,837 |
| Add: Effect of dilutive securities:  |                    |        |                   |        |
| Stock options  | 124                | 19     | 9                 | 18     |
| Shares held by deferred compensation plan  | 39                 | 41     | 40                | 41     |
| Average diluted shares outstanding   | 17,210             | 17,621 | 17,194            | 17,896 |

For the three months ended September 30, 2013 and 2012, antidilutive stock options of 584,000 and 1,101,000, respectively, were excluded from earnings per share calculations. For the nine months ended September 30, 2013 and 2012, antidilutive stock options of 948,000 and 1,168,000, respectively, were excluded from earnings per share calculations.

**Table of Contents****Note 3. Securities**

The amortized cost and estimated fair value of securities available-for-sale and held-to-maturity at September 30, 2013 and December 31, 2012 are as follows (in thousands):

|   |                   | At September 30, 2013  |                         |                      |
|---|-------------------|------------------------|-------------------------|----------------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| <b>Available-for-sale:</b>                            |                   |                        |                         |                      |
| <b>Investment securities:</b>                         |                   |                        |                         |                      |
| U.S. agency obligations                               | \$ 60,191         | \$ 293                 | \$                      | \$ 60,484            |
| Equity investments                                    | 7,395             | 1,102                  | (13)                    | 8,484                |
| <b>Total investment securities available-for-sale</b> | <b>\$ 67,586</b>  | <b>\$ 1,395</b>        | <b>\$ (13)</b>          | <b>\$ 68,968</b>     |
| <b>Held-to-maturity:</b>                              |                   |                        |                         |                      |
| <b>Investment securities:</b>                         |                   |                        |                         |                      |
| U.S. agency obligations                               | \$ 82,660         | \$ 149                 | \$ (186)                | \$ 82,623            |
| State and municipal obligations                       | 23,015            | 17                     | (94)                    | 22,938               |
| Corporate debt securities                             | 55,000            |                        | (10,124)                | 44,876               |
| <b>Total investment securities</b>                    | <b>160,675</b>    | <b>166</b>             | <b>(10,404)</b>         | <b>150,437</b>       |
| <b>Mortgage-backed securities:</b>                    |                   |                        |                         |                      |
| FHLMC   | 154,193           | 734                    | (3,478)                 | 151,449              |
| FNMA  | 211,676           | 5,367                  | (2,607)                 | 214,436              |
| GNMA  | 746               | 105                    |                         | 851                  |
| <b>Total mortgage-backed securities</b>               | <b>366,615</b>    | <b>6,206</b>           | <b>(6,085)</b>          | <b>366,736</b>       |
| <b>Total held-to-maturity</b>                         | <b>\$ 527,290</b> | <b>\$ 6,372</b>        | <b>\$ (16,489)</b>      | <b>\$ 517,173</b>    |
| <b>Total securities</b>                               | <b>\$ 594,876</b> | <b>\$ 7,767</b>        | <b>\$ (16,502)</b>      | <b>\$ 586,141</b>    |

|                                 |                | At December 31, 2012   |                         |                      |
|---------------------------------|----------------|------------------------|-------------------------|----------------------|
|                                 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| <b>Available-for-sale:</b>      |                |                        |                         |                      |
| <b>Investment securities:</b>   |                |                        |                         |                      |
| U.S. agency obligations         | \$ 138,105     | \$ 945                 | \$                      | \$ 139,050           |
| State and municipal obligations | 25,856         | 5                      | (81)                    | 25,780               |
| Corporate debt securities       | 55,000         |                        | (11,530)                | 43,470               |

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|                                  |            |           |             |            |
|----------------------------------|------------|-----------|-------------|------------|
| Equity investments               | 4,992      | 424       | (123)       | 5,293      |
|                                  | 223,953    | 1,374     | (11,734)    | 213,593    |
| Mortgage-backed-securities:      |            |           |             |            |
| FHLMC                            | 118,294    | 1,284     | (53)        | 119,525    |
| FNMA                             | 204,296    | 9,017     | (11)        | 213,302    |
| GNMA                             | 824        | 206       |             | 1,030      |
| Total mortgage-backed securities | 323,414    | 10,507    | (64)        | 333,857    |
| Total available-for-sale         | \$ 547,367 | \$ 11,881 | \$ (11,798) | \$ 547,450 |

The changes in held-to-maturity and available-for-sale securities for the period ending September 30, 2013 are primarily attributed to a \$536.0 million transfer of previously-designated available-for-sale securities to a held-to-maturity designation at fair value. The reclassification for the period ended September 30, 2013 is permitted as the Company has appropriately determined the ability and intent to hold these securities as an investment until maturity or call. The securities transferred had an unrealized net loss of \$13.3 million at the time of transfer which continues to be reflected in accumulated other comprehensive loss on the consolidated balance sheet, net of subsequent amortization, which is being recognized over the life of the securities. The carrying value of the held-to-maturity investment securities at September 30, 2013 is as follows (in thousands):

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|  |            |
|--|------------|
| Amortized cost                                       | \$ 527,290 |
| Net loss on date of transfer from available-for-sale | (13,347)   |
| Amortization of net loss                             | 79         |
| Carrying value                                       | \$ 514,022 |

Realized gains on the sale of securities were \$42,000 and \$226,000, respectively, for the nine months ended September 30, 2013 and 2012. There were no realized gains or losses on the sale of securities for the three months ended September 30, 2013 and 2012.

The amortized cost and estimated fair value of investment securities, excluding equity investments, at September 30, 2013 by contractual maturity, are shown below (in thousands). Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. At September 30, 2013, corporate debt securities with an amortized cost and estimated market value of \$55.0 million and \$44.9 million, respectively, were callable prior to the maturity date.

|  | Amortized<br>Cost | Estimated<br>Fair<br>Value |
|--|-------------------|----------------------------|
| September 30, 2013                     |                   |                            |
| Less than one year                     | \$ 57,609         | \$ 57,851                  |
| Due after one year through five years  | 107,024           | 107,003                    |
| Due after five years through ten years | 1,233             | 1,191                      |
| Due after ten years                    | 55,000            | 44,876                     |
|  | \$ 220,866        | \$ 210,921                 |

Mortgage-backed securities are excluded from the above table since their effective lives are expected to be shorter than the contractual maturity date due to principal prepayments.

The estimated fair value and unrealized loss for securities available-for-sale and held-to-maturity at September 30, 2013 and December 31, 2012, segregated by the duration of the unrealized loss, are as follows (in thousands):

|   | Less than 12 months        |                      | At September 30, 2013<br>12 months or longer |                      | Total                      |                      |
|---|----------------------------|----------------------|--|----------------------|----------------------------|----------------------|
|   | Estimated<br>Fair<br>Value | Unrealized<br>Losses | Estimated<br>Fair<br>Value                   | Unrealized<br>Losses | Estimated<br>Fair<br>Value | Unrealized<br>Losses |
| Available-for-sale:                               |                            |                      |  |                      |                            |                      |
| Investment securities:                            |                            |                      |  |                      |                            |                      |
| Equity investments                                | \$ 581                     | \$ (13)              | \$   | \$                   | \$ 581                     | \$ (13)              |
| Total investment securities<br>available-for-sale | \$ 581                     | \$ (13)              | \$   | \$                   | \$ 581                     | \$ (13)              |

|                                    |                   |                   |                  |                    |                   |                    |
|------------------------------------|-------------------|-------------------|------------------|--------------------|-------------------|--------------------|
| <b>Held-to-maturity:</b>           |                   |                   |                  |                    |                   |                    |
| <b>Investment securities:</b>      |                   |                   |                  |                    |                   |                    |
| U.S. agency obligations            | \$ 35,786         | \$ (186)          | \$               | \$                 | \$ 35,786         | \$ (186)           |
| State and municipal obligations    | 10,614            | (93)              | 211              | (1)                | 10,825            | (94)               |
| Corporate debt securities          |                   |                   | 44,876           | (10,124)           | 44,876            | (10,124)           |
| Total investment securities        | 46,400            | (279)             | 45,087           | (10,125)           | 91,487            | (10,404)           |
| <b>Mortgage-backed securities:</b> |                   |                   |                  |                    |                   |                    |
| FHLMC                              | 114,416           | (3,478)           |                  |                    | 114,416           | (3,478)            |
| FNMA                               | 75,743            | (2,607)           |                  |                    | 75,743            | (2,607)            |
| Total mortgage-backed securities   | 190,159           | (6,085)           |                  |                    | 190,159           | (6,085)            |
| <b>Total held-to-maturity</b>      | <b>\$ 236,559</b> | <b>\$ (6,364)</b> | <b>\$ 45,087</b> | <b>\$ (10,125)</b> | <b>\$ 281,646</b> | <b>\$ (16,489)</b> |
| <b>Total securities</b>            | <b>\$ 237,140</b> | <b>\$ (6,377)</b> | <b>\$ 45,087</b> | <b>\$ (10,125)</b> | <b>\$ 282,227</b> | <b>\$ (16,502)</b> |

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|   | At December 31, 2012 |                   |                      |                    |                      |                    |
|---|----------------------|-------------------|----------------------|--------------------|----------------------|--------------------|
|   | Less than 12 months  |                   | 12 months or longer  |                    | Total                |                    |
|   | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses  | Estimated Fair Value | Unrealized Losses  |
| <b>Available-for-sale:</b>              |                      |                   |                      |                    |                      |                    |
| <b>Investment securities:</b>           |                      |                   |                      |                    |                      |                    |
| State and municipal obligations         | \$ 15,918            | \$ (81)           | \$                   | \$                 | \$ 15,918            | \$ (81)            |
| Corporate debt securities               |                      |                   | 43,470               | (11,530)           | 43,470               | (11,530)           |
| Equity investments                      | 1,264                | (123)             |                      |                    | 1,264                | (123)              |
| <b>Total investment securities</b>      | <b>17,182</b>        | <b>(204)</b>      | <b>43,470</b>        | <b>(11,530)</b>    | <b>60,652</b>        | <b>(11,734)</b>    |
| <b>Mortgage-backed securities:</b>      |                      |                   |                      |                    |                      |                    |
| FHLMC                                   | 16,186               | (53)              |                      |                    | 16,186               | (53)               |
| FNMA                                    | 4,871                | (11)              |                      |                    | 4,871                | (11)               |
| <b>Total mortgage-backed securities</b> | <b>21,057</b>        | <b>(64)</b>       |                      |                    | <b>21,057</b>        | <b>(64)</b>        |
| <b>Total available-for-sale</b>         | <b>\$ 38,239</b>     | <b>\$ (268)</b>   | <b>\$ 43,470</b>     | <b>\$ (11,530)</b> | <b>\$ 81,709</b>     | <b>\$ (11,798)</b> |

At September 30, 2013, the amortized cost, estimated fair value and credit rating of the individual corporate debt securities in an unrealized loss position for greater than one year are as follows (in thousands):

| Security Description | Amortized Cost   | Estimated Fair Value | Credit Rating Moody's/S&P |
|----------------------|------------------|----------------------|---------------------------|
| BankAmerica Capital  | \$ 15,000        | \$ 12,038            | Ba2/BB+                   |
| Chase Capital        | 10,000           | 8,102                | Baa2/BBB                  |
| Wells Fargo Capital  | 5,000            | 4,226                | A3/A-                     |
| Huntington Capital   | 5,000            | 3,931                | Baa3/BB+                  |
| Keycorp Capital      | 5,000            | 4,108                | Baa3/BBB-                 |
| PNC Capital          | 5,000            | 4,217                | Baa2/BBB                  |
| State Street Capital | 5,000            | 4,168                | A3/BBB+                   |
| SunTrust Capital     | 5,000            | 4,086                | Baa3/BB+                  |
|                      | <b>\$ 55,000</b> | <b>\$ 44,876</b>     |                           |

At September 30, 2013, the fair value of each corporate debt security was below cost. However, the estimated fair value of the corporate debt securities increased as compared to December 31, 2012. The corporate debt securities are issued by other financial institutions with credit ratings ranging from a high of A3 to a low of Ba2 as rated by one of the internationally-recognized credit rating services. These floating-rate securities were purchased in 1998 and have paid coupon interest continuously since issuance. Floating-rate debt securities such as these pay a fixed interest rate spread over 90-day LIBOR. Following the purchase of these securities, the required spread increased for these types of securities causing a decline in the market price. The Company concluded that unrealized losses on corporate debt securities were only temporarily impaired at September 30, 2013. In concluding that the impairments were only



temporary, the Company considered several factors in its analysis. The Company noted that each issuer made all the contractually due payments when required. There were no defaults on principal or interest payments and no interest payments were deferred. All of the financial institutions are also considered well-capitalized. Recently, credit spreads have decreased for these types of securities and market prices have improved. Based on management's analysis of each individual security, the issuers appear to have the ability to meet debt service requirements over the life of the security. Furthermore, the Company does not have the intent to sell these securities and it is more likely than not that the Company will not be required to sell the securities. The Company has held the securities continuously since 1998 and expects to receive its full principal at maturity in 2028 or prior if called by the issuer. The Company has historically not actively sold investment securities and does not utilize the securities portfolio as a source of liquidity. The Company's long range liquidity plans indicate adequate sources of liquidity outside the securities portfolio.

The mortgage-backed securities are issued and guaranteed by either the Federal Home Loan Mortgage Corporation ( FHLMC ) or Federal National Mortgage Association ( FNMA ), corporations which are chartered by the United States Government and whose debt obligations are typically rated AA+ by one of the internationally-recognized credit rating services. FHLMC and FNMA have been under the conservatorship of the Federal Housing Financial Agency since September 8, 2008. The conservatorships have no specified termination date. Also, FHLMC and FNMA have entered into Stock Purchase Agreements, which following the issuance of Senior Preferred Stock and Warrants to the United States Treasury, provide FHLMC and FNMA funding commitments from the United States Treasury. The Company considers the unrealized losses to be the result of changes in interest rates which over time can have both a positive and negative impact

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on the estimated market value of the mortgage-backed securities. The Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell the securities before recovery of their amortized cost. As a result, the Company concluded that these securities were only temporarily impaired at September 30, 2013.

**Note 4. Loans Receivable, Net**

Loans receivable, net at September 30, 2013 and December 31, 2012 consisted of the following (in thousands):

|   | September 30,<br>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
| <b>Real estate:</b>                           |                       |                      |
| One-to-four family                            | \$ 766,099            | \$ 802,959           |
| Commercial real estate, multi family and land | 497,461               | 475,155              |
| Residential construction                      | 17,087                | 9,013                |
| Consumer                                      | 199,761               | 198,143              |
| Commercial and industrial                     | 65,584                | 57,967               |
| <b>Total loans</b>                            | <b>1,545,992</b>      | <b>1,543,237</b>     |
| Loans in process                              | (6,530)               | (3,639)              |
| Deferred origination costs, net               | 3,850                 | 4,112                |
| Allowance for loan losses                     | (20,887)              | (20,510)             |
| <b>Loans receivable, net</b>                  | <b>\$ 1,522,425</b>   | <b>\$ 1,523,200</b>  |

At September 30, 2013 and December 31, 2012, loans in the amount of \$41,565,000 and \$43,374,000, respectively, were three or more months delinquent or in the process of foreclosure and the Company was not accruing interest income on these loans. There were no loans ninety days or greater past due and still accruing interest. Non-accrual loans include both smaller balance homogenous loans that are collectively evaluated for impairment and individually classified impaired loans.

The Company defines an impaired loan as all non-accrual commercial real estate, multi-family, land, construction and commercial loans in excess of \$250,000. Impaired loans also include all loans modified as troubled debt restructurings. At September 30, 2013, the impaired loan portfolio totaled \$37,513,000 for which there was a specific allocation in the allowance for loan losses of \$3,333,000. At December 31, 2012, the impaired loan portfolio totaled \$37,546,000 for which there was a specific allocation in the allowance for loan losses of \$2,554,000. The average balance of impaired loans for the three and nine months ended September 30, 2013 was \$36,320,000 and \$39,045,000, respectively and \$35,802,000 and \$31,131,000, respectively, for the same prior year periods.

An analysis of the allowance for loan losses for the three and nine months ended September 30, 2013 and 2012 is as follows (in thousands):

| Three months ended<br>September 30, | Nine months ended<br>September 30, |
|-------------------------------------|------------------------------------|
|-------------------------------------|------------------------------------|

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|                                 | 2013      | 2012      | 2013      | 2012      |
|---------------------------------|-----------|-----------|-----------|-----------|
| Balance at beginning of period  | \$ 20,820 | \$ 17,657 | \$ 20,510 | \$ 18,230 |
| Provision charged to operations | 700       | 1,400     | 2,600     | 4,800     |
| Charge-offs                     | (768)     | (1,694)   | (3,068)   | (6,037)   |
| Recoveries                      | 135       | 928       | 845       | 1,298     |
| Balance at end of period        | \$ 20,887 | \$ 18,291 | \$ 20,887 | \$ 18,291 |

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The following table presents an analysis of the allowance for loan losses for the three and nine months ended September 30, 2013 and 2012 and the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2013 and December 31, 2012 (in thousands):

|   | Residential<br>Real Estate | Commercial<br>Real<br>Estate | Consumer | Commercial | Unallocated | Total     |
|---|----------------------------|------------------------------|----------|------------|-------------|-----------|
| <b><u>For the three months ended</u></b>  |                            |                              |          |            |             |           |
| <b><u>September 30, 2013</u></b>          |                            |                              |          |            |             |           |
| Allowance for loan losses:                |                            |                              |          |            |             |           |
| Balance at beginning of period            | 4,900                      | \$ 9,774                     | \$ 1,939 | \$ 1,093   | \$ 3,114    | \$ 20,820 |
| Provision (benefit) charged to operations | 110                        | (328)                        | 192      | 419        | 307         | 700       |
| Charge-offs                               | (328)                      |                              | (440)    |            |             | (768)     |
| Recoveries                                | 60                         |                              | 75       |            |             | 135       |
| Balance at end of period                  | \$ 4,742                   | \$ 9,446                     | \$ 1,766 | \$ 1,512   | \$ 3,421    | \$ 20,887 |

**For the three months ended**  
**September 30, 2012**

|   |          |          |          |          |          |           |
|---|----------|----------|----------|----------|----------|-----------|
| Allowance for loan losses:                |          |          |          |          |          |           |
| Balance at beginning of period            | \$ 4,768 | \$ 8,614 | \$ 1,648 | \$ 1,110 | \$ 1,517 | \$ 17,657 |
| Provision (benefit) charged to operations | 609      | (90)     | 963      | (577)    | 495      | 1,400     |
| Charge-offs                               | (1,126)  |          | (491)    | (77)     |          | (1,694)   |
| Recoveries                                | 210      |          | 104      | 614      |          | 928       |
| Balance at end of period                  | \$ 4,461 | \$ 8,524 | \$ 2,224 | \$ 1,070 | \$ 2,012 | \$ 18,291 |

**For the nine months ended**  
**September 30, 2013**

|   |          |          |          |          |          |           |
|---|----------|----------|----------|----------|----------|-----------|
| Allowance for loan losses:                |          |          |          |          |          |           |
| Balance at beginning of period            | \$ 5,241 | \$ 8,937 | \$ 2,264 | \$ 1,348 | \$ 2,720 | \$ 20,510 |
| Provision (benefit) charged to operations | 959      | 459      | 85       | 396      | 701      | 2,600     |
| Charge-offs                               | (2,017)  |          | (816)    | (235)    |          | (3,068)   |
| Recoveries                                | 559      | 50       | 233      | 3        |          | 845       |
| Balance at end of period                  | \$ 4,742 | \$ 9,446 | \$ 1,766 | \$ 1,512 | \$ 3,421 | \$ 20,887 |

**For the nine months ended**  
**September 30, 2012**

|   |          |          |          |          |          |           |
|---|----------|----------|----------|----------|----------|-----------|
| Allowance for loan losses:                |          |          |          |          |          |           |
| Balance at beginning of period            | \$ 5,370 | \$ 8,474 | \$ 1,461 | \$ 900   | \$ 2,025 | \$ 18,230 |
| Provision (benefit) charged to operations | 2,710    | (57)     | 2,533    | (373)    | (13)     | 4,800     |
| Charge-offs                               | (4,030)  | (47)     | (1,882)  | (78)     |          | (6,037)   |
| Recoveries                                | 411      | 154      | 112      | 621      |          | 1,298     |
| Balance at end of period                  | \$ 4,461 | \$ 8,524 | \$ 2,224 | \$ 1,070 | \$ 2,012 | \$ 18,291 |



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|   | Residential<br>Real Estate | Commercial<br>Real<br>Estate | Consumer   | Commercial | Unallocated | Total        |
|---|----------------------------|------------------------------|------------|------------|-------------|--------------|
| <b>September 30, 2013</b>                     |                            |                              |            |            |             |              |
| Allowance for loan losses:                    |                            |                              |            |            |             |              |
| Ending allowance balance attributed to loans: |                            |                              |            |            |             |              |
| Individually evaluated for impairment         | \$ 155                     | \$ 2,736                     | \$ 442     | \$         | \$          | \$ 3,333     |
| Collectively evaluated for impairment         | 4,587                      | 6,710                        | 1,324      | 1,512      | 3,421       | 17,554       |
| Total ending allowance balance                | \$ 4,742                   | \$ 9,446                     | \$ 1,766   | \$ 1,512   | \$ 3,421    | \$ 20,887    |
| Loans:  |                            |                              |            |            |             |              |
| Loans individually evaluated for impairment   | \$ 19,485                  | \$ 13,716                    | \$ 3,520   | \$ 792     | \$          | \$ 37,513    |
| Loans collectively evaluated for impairment   | 763,701                    | 483,745                      | 196,241    | 64,792     |             | 1,508,479    |
| Total ending loan balance                     | \$ 783,186                 | \$ 497,461                   | \$ 199,761 | \$ 65,584  | \$          | \$ 1,545,992 |
| <b>December 31, 2012</b>                      |                            |                              |            |            |             |              |
| Allowance for loan losses:                    |                            |                              |            |            |             |              |
| Ending allowance balance attributed to loans: |                            |                              |            |            |             |              |
| Individually evaluated for impairment         | \$ 179                     | \$ 1,834                     | \$ 541     | \$         | \$          | \$ 2,554     |
| Collectively evaluated for impairment         | 5,062                      | 7,103                        | 1,723      | 1,348      | 2,720       | 17,956       |
| Total ending allowance balance                | \$ 5,241                   | \$ 8,937                     | \$ 2,264   | \$ 1,348   | \$ 2,720    | \$ 20,510    |
| Loans:  |                            |                              |            |            |             |              |
| Loans individually evaluated for impairment   | \$ 22,427                  | \$ 12,116                    | \$ 2,712   | \$ 291     | \$          | \$ 37,546    |
| Loans collectively evaluated for impairment   | 789,545                    | 463,039                      | 195,431    | 57,676     |             | 1,505,691    |
| Total ending loan balance                     | \$ 811,972                 | \$ 475,155                   | \$ 198,143 | \$ 57,967  | \$          | \$ 1,543,237 |

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A summary of impaired loans at September 30, 2013 and December 31, 2012 is as follows (in thousands):

|  | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| Impaired loans with no allocated allowance for loan losses | \$ 26,122             | \$ 25,513            |
| Impaired loans with allocated allowance for loan losses    | 11,391                | 12,033               |
|  | \$ 37,513             | \$ 37,546            |
| Amount of the allowance for loan losses allocated          | \$ 3,333              | \$ 2,554             |

At September 30, 2013, impaired loans include troubled debt restructuring loans of \$33,409,000 of which \$21,523,000 were performing in accordance with their restructured terms for a minimum of six months and were accruing interest. At December 31, 2012, impaired loans include troubled debt restructuring loans of \$35,893,000 of which \$17,733,000 were performing in accordance with their restructured terms and were accruing interest.

The summary of loans individually evaluated for impairment by class of loans as of September 30, 2013 and December 31, 2012 and for the three and nine months ended September 30, 2013 and 2012 follows (in thousands):

|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated |
|--|--------------------------------|------------------------|--|
| <u>As of September 30, 2013</u>          |                                |                        |  |
| With no related allowance recorded:      |                                |                        |  |
| Residential real estate:                 |                                |                        |  |
| Originated by Bank                       | \$ 9,672                       | \$ 9,001               | \$   |
| Originated by mortgage company           | 7,409                          | 7,034                  |  |
| Originated by mortgage company non-prime | 2,773                          | 2,171                  |  |
| Commercial real estate:                  |                                |                        |  |
| Commercial                               | 4,356                          | 4,333                  |  |
| Construction and land                    |                                |                        |  |
| Consumer                                 | 3,108                          | 2,791                  |  |
| Commercial                               | 792                            | 792                    |  |
|  | \$ 28,110                      | \$ 26,122              | \$   |
| With an allowance recorded:              |                                |                        |  |
| Residential real estate:                 |                                |                        |  |
| Originated by Bank                       | \$ 881                         | \$ 881                 | \$ 124                                       |
| Originated by mortgage company           | 398                            | 398                    | 31   |
| Originated by mortgage company non-prime |                                |                        |  |

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Commercial real estate:

|                       |           |           |          |
|-----------------------|-----------|-----------|----------|
| Commercial            | 9,096     | 9,074     | 2,513    |
| Construction and land | 309       | 309       | 223      |
| Consumer              | 852       | 729       | 442      |
| Commercial            |           |           |          |
|                       | \$ 11,536 | \$ 11,391 | \$ 3,333 |

As of December 31, 2012

With no related allowance recorded:

Residential real estate:

|  |           |           |    |
|--|-----------|-----------|----|
| Originated by Bank                       | \$ 11,200 | \$ 10,956 | \$ |
| Originated by mortgage company           | 7,210     | 7,061     |    |
| Originated by mortgage company non-prime | 2,335     | 2,251     |    |
| Commercial real estate:                  |           |           |    |
| Commercial                               | 2,722     | 2,691     |    |
| Construction and land                    | 482       | 482       |    |
| Consumer                                 | 1,956     | 1,781     |    |
| Commercial                               | 291       | 291       |    |
|  | \$ 26,196 | \$ 25,513 | \$ |



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|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated |
|--|--------------------------------|------------------------|--|
| With an allowance recorded:              |                                |                        |  |
| Residential real estate:                 |                                |                        |  |
| Originated by Bank                       | \$ 1,761                       | \$ 1,755               | \$ 142                                       |
| Originated by mortgage company           | 404                            | 404                    | 37   |
| Originated by mortgage company non-prime |                                |                        |  |
| Commercial real estate:                  |                                |                        |  |
| Commercial                               | 9,022                          | 8,943                  | 1,834  |
| Construction and land                    |                                |                        |  |
| Consumer                                 | 934                            | 931                    | 541  |
| Commercial                               |                                |                        |  |
|  | \$ 12,121                      | \$ 12,033              | \$ 2,554                                     |

|  | Three months ended September 30,<br>2013 |                                  | 2012                              |                                  |
|--|--|----------------------------------|-----------------------------------|----------------------------------|
|  | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| With no related allowance recorded:      |  |                                  |                                   |                                  |
| Residential real estate:                 |  |                                  |                                   |                                  |
| Originated by Bank                       | \$ 9,411                                 | \$ 87                            | \$ 10,440                         | \$ 125                           |
| Originated by mortgage company           | 6,737                                    | 68                               | 6,824                             | 68                               |
| Originated by mortgage company non-prime | 2,180                                    | 3                                | 1,960                             | 1                                |
| Commercial real estate:                  |  |                                  |                                   |                                  |
| Commercial                               | 3,296                                    | 36                               | 1,710                             | 22                               |
| Construction and land                    |  |                                  |                                   |                                  |
| Consumer                                 | 2,742                                    | 19                               | 1,406                             | 19                               |
| Commercial                               | 793                                      |                                  | 294                               | 3                                |
|  | \$ 25,159                                | \$ 213                           | \$ 22,634                         | \$ 238                           |

|  |        |       |          |       |
|--|--------|-------|----------|-------|
| With an allowance recorded:              |        |       |          |       |
| Residential real estate:                 |        |       |          |       |
| Originated by Bank                       | \$ 881 | \$ 11 | \$ 1,605 | \$ 14 |
| Originated by mortgage company           | 265    | 7     | 405      | 7     |
| Originated by mortgage company non-prime |        |       | 636      |       |
| Commercial real estate:                  |        |       |          |       |
| Commercial                               | 8,977  | 15    | 9,834    | 89    |
| Construction and land                    | 309    |       |          |       |
| Consumer                                 | 729    | 10    | 688      | 10    |
| Commercial                               |        |       |          |       |

\$ 11,161      \$      43      \$ 13,168      \$      120

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|  | Nine months ended September 30, |                            |                             |                            |
|--|---------------------------------|----------------------------|-----------------------------|----------------------------|
|  | 2013                            |                            | 2012                        |                            |
|  | Average Recorded Investment     | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| <b>With no related allowance recorded:</b> |                                 |                            |                             |                            |
| Residential real estate:                   |                                 |                            |                             |                            |
| Originated by Bank                         | \$ 10,841                       | \$ 262                     | \$ 9,291                    | \$ 324                     |
| Originated by mortgage company             | 7,158                           | 202                        | 5,686                       | 178                        |
| Originated by mortgage company non-prime   | 2,211                           | 12                         | 1,832                       | 3                          |
| Commercial real estate:                    |                                 |                            |                             |                            |
| Commercial                                 | 2,925                           | 103                        | 1,643                       | 66                         |
| Construction and land                      |                                 |                            |                             |                            |
| Consumer                                   | 3,757                           | 58                         | 952                         | 38                         |
| Commercial                                 | 456                             | 5                          | 296                         | 7                          |
|  | \$ 27,348                       | \$ 642                     | \$ 19,700                   | \$ 616                     |
| <b>With an allowance recorded:</b>         |                                 |                            |                             |                            |
| Residential real estate:                   |                                 |                            |                             |                            |
| Originated by Bank                         | \$ 852                          | \$ 33                      | \$ 1,050                    | \$ 61                      |
| Originated by mortgage company             | 356                             | 20                         | 135                         | 7                          |
| Originated by mortgage company non-prime   |                                 |                            | 674                         |                            |
| Commercial real estate:                    |                                 |                            |                             |                            |
| Commercial                                 | 9,232                           | 172                        | 9,255                       | 277                        |
| Construction and land                      | 418                             |                            |                             |                            |
| Consumer                                   | 839                             | 32                         | 317                         | 11                         |
| Commercial                                 |                                 |                            |                             |                            |
|  | \$ 11,697                       | \$ 257                     | \$ 11,431                   | \$ 356                     |

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

|  | September 30, 2013 | December 31, 2012 |
|--|--------------------|-------------------|
| Residential real estate:                 |                    |                   |
| Originated by Bank                       | \$ 15,661          | \$ 13,156         |
| Originated by mortgage company           | 10,402             | 10,477            |
| Originated by mortgage company non-prime | 2,907              | 2,888             |
| Commercial real estate:                  |                    |                   |
| Commercial                               | 7,089              | 11,085            |
| Construction and land                    | 309                | 482               |
| Consumer                                 | 4,428              | 4,540             |
| Commercial                               | 769                | 746               |

\$ 41,565      \$ 43,374

As used in these footnotes, loans Originated by mortgage company are mortgage loans originated under the Bank's underwriting guidelines by the Bank's shuttered mortgage company, and retained as part of the Bank's mortgage portfolio. These loans have significantly higher delinquency rates than similar loans originated by the Bank. Loans Originated by mortgage company non-prime are subprime or Alt-A loans which were originated for sale into the secondary market by the Bank's shuttered mortgage company.

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The following table presents the aging of the recorded investment in past due loans as of September 30, 2013 and December 31, 2012 by class of loans (in thousands):

|  | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | Greater<br>than<br>90 Days<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total        |
|--|---------------------------|---------------------------|--|-------------------|-----------------------|--------------|
| <b>September 30, 2013</b>                |                           |                           |  |                   |                       |              |
| Residential real estate:                 |                           |                           |  |                   |                       |              |
| Originated by Bank                       | \$ 7,069                  | \$ 1,523                  | \$ 14,286                              | \$ 22,878         | \$ 642,770            | \$ 665,648   |
| Originated by mortgage company           |                           | 958                       | 10,293                                 | 11,251            | 85,151                | 96,402       |
| Originated by mortgage company non-prime | 167                       | 185                       | 2,343                                  | 2,695             | 1,354                 | 4,049        |
| Residential construction                 |                           |                           |  |                   | 17,087                | 17,087       |
| Commercial real estate:                  |                           |                           |  |                   |                       |              |
| Commercial                               | 3,758                     | 6,219                     | 3,866                                  | 13,843            | 465,132               | 478,975      |
| Construction and land                    |                           |                           | 490                                    | 490               | 17,996                | 18,486       |
| Consumer                                 | 717                       | 198                       | 4,394                                  | 5,309             | 194,452               | 199,761      |
| Commercial                               | 71                        | 425                       | 932                                    | 1,428             | 64,156                | 65,584       |
|  | \$ 11,782                 | \$ 9,508                  | \$ 36,604                              | \$ 57,894         | \$ 1,488,098          | \$ 1,545,992 |
| <b>December 31, 2012</b>                 |                           |                           |  |                   |                       |              |
| Residential real estate:                 |                           |                           |  |                   |                       |              |
| Originated by Bank                       | \$ 5,863                  | \$ 782                    | \$ 10,624                              | \$ 17,269         | \$ 666,833            | \$ 684,102   |
| Originated by mortgage company           | 2,870                     | 7                         | 10,294                                 | 13,171            | 101,437               | 114,608      |
| Originated by mortgage company non-prime | 431                       | 47                        | 2,369                                  | 2,847             | 1,402                 | 4,249        |
| Residential construction                 |                           |                           |  |                   | 9,013                 | 9,013        |
| Commercial real estate:                  |                           |                           |  |                   |                       |              |
| Commercial                               | 2,422                     | 608                       | 2,863                                  | 5,893             | 457,394               | 463,287      |
| Construction and land                    |                           |                           | 482                                    | 482               | 11,386                | 11,868       |
| Consumer                                 | 719                       | 576                       | 4,457                                  | 5,752             | 192,391               | 198,143      |
| Commercial                               |                           |                           | 112                                    | 112               | 57,855                | 57,967       |
|  | \$ 12,305                 | \$ 2,020                  | \$ 31,201                              | \$ 45,526         | \$ 1,497,711          | \$ 1,543,237 |

The Company categorizes all commercial and commercial real estate loans, except for small business loans, into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation and current economic trends, among other factors. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

**Special Mention.** Loans classified as Special Mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Bank's credit position at some future date.

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

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

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Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be Pass rated loans. Loans not rated are included in groups of homogeneous loans. As of September 30, 2013 and December 31, 2012, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows (in thousands):

|                           | Pass       | Special<br>Mention | Substandard | Doubtful | Total      |
|---------------------------|------------|--------------------|-------------|----------|------------|
| <b>September 30, 2013</b> |            |                    |             |          |            |
| Commercial real estate:   |            |                    |             |          |            |
| Commercial                | \$ 445,433 | \$ 25              | \$ 32,638   | \$ 879   | \$ 478,975 |
| Construction and land     | 17,671     | 506                | 309         |          | 18,486     |
| Commercial                | 61,817     | 3,380              | 387         |          | 65,584     |
|                           | \$ 524,921 | \$ 3,911           | \$ 33,334   | \$ 879   | \$ 563,045 |
| <b>December 31, 2012</b>  |            |                    |             |          |            |
| Commercial real estate:   |            |                    |             |          |            |
| Commercial                | \$ 429,393 | \$ 1,775           | \$ 31,275   | \$ 844   | \$ 463,287 |
| Construction and land     | 10,880     | 506                | 482         |          | 11,868     |
| Commercial                | 57,341     |                    | 391         | 235      | 57,967     |
|                           | \$ 497,614 | \$ 2,281           | \$ 32,148   | \$ 1,079 | \$ 533,122 |

For residential and consumer loan classes, the Company evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity as of September 30, 2013 and December 31, 2012 (in thousands):

|                           | Residential Real Estate |                                      |   |                             |            |
|---------------------------|-------------------------|--------------------------------------|---|-----------------------------|------------|
|                           | Originated<br>by Bank   | Originated by<br>mortgage<br>company | Originated by<br>mortgage<br>company<br>non-prime | Residential<br>construction | Consumer   |
| <b>September 30, 2013</b> |                         |                                      |   |                             |            |
| Performing                | \$ 649,987              | \$ 86,000                            | \$ 1,142  | \$ 17,087                   | \$ 195,333 |
| Non-performing            | 15,661                  | 10,402                               | 2,907   |                             | 4,428      |
|                           | \$ 665,648              | \$ 96,402                            | \$ 4,049  | \$ 17,087                   | \$ 199,761 |
| <b>December 31, 2012</b>  |                         |                                      |   |                             |            |
| Performing                | \$ 670,946              | \$ 104,131                           | \$ 1,361  | \$ 9,013                    | \$ 193,603 |
| Non-performing            | 13,156                  | 10,477                               | 2,888   |                             | 4,540      |
|                           | \$ 684,102              | \$ 114,608                           | \$ 4,249  | \$ 9,013                    | \$ 198,143 |

The Company classifies certain loans as troubled debt restructurings when credit terms to a borrower in financial difficulty are modified. The modifications may include a reduction in rate, an extension in term and/or the capitalization of past due amounts. Included in the non-accrual loan total at September 30, 2013 and December 31, 2012 were \$11,886,000 and \$18,160,000, respectively, of troubled debt restructurings. At September 30, 2013 and December 31, 2012, the Company has allocated \$2,400,000 and \$2,418,000, respectively, of specific reserves to loans which are classified as troubled debt restructurings. Non-accrual loans which become troubled debt restructurings are generally returned to accrual status after six months of performance. In addition to the troubled debt restructurings included in non-accrual loans, the Company also has loans classified as troubled debt restructurings which are accruing at September 30, 2013 and December 31, 2012, which totaled \$21,523,000 and \$17,733,000, respectively. Non-accruing and accruing troubled debt restructurings at September 30, 2013 include \$2,686,000 and \$4,804,000, respectively, and at December 31, 2012 include \$1,704,000 and \$6,291,000, respectively, relating to the implementation of new guidance issued by the Bank's regulator, the Office of the Comptroller of the Currency ( OCC ). The amount now includes one-to-four family and consumer loans where the borrower's obligation was discharged due to bankruptcy. The updated guidance requires the Company to include certain loans as troubled debt restructurings due to the discharge of the borrower's debt. These loans continue to make payments as agreed and the Bank retains its security interest in the real estate collateral. Troubled debt restructurings with six months of performance are considered in the allowance for loan losses similar to other performing loans. Troubled debt restructurings which are non-accrual or classified are considered in the allowance for loan losses similar to other non-accrual or classified loans.



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The following table presents information about troubled debt restructurings which occurred during the three and nine months ended September 30, 2013 and 2012 and troubled debt restructurings modified within the previous year and which defaulted during the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

|   | Number of Loans    | Pre-modification<br>Recorded Investment    | Post-modification<br>Recorded Investment    |
|---|--------------------|--|---|
| <b><u>Three months ended September 30, 2013</u></b>           |                    |  |   |
| Troubled Debt Restructurings:                                 |                    |  |   |
| Residential real estate:                                      |                    |  |   |
| Originated by mortgage company                                | 2                  | \$ 779                                     | \$ 777                                      |
| Consumer  | 2                  | 205  | 125   |
|   | Number<br>of Loans | Recorded<br>Investment                     |   |
| Troubled Debt Restructurings<br>Which Subsequently Defaulted: |                    |  |   |
| Consumer  | 1                  | 12   |   |
|   | Number<br>of Loans | Pre-modification<br>Recorded<br>Investment | Post-modification<br>Recorded<br>Investment |
| <b><u>Nine months ended September 30, 2013</u></b>            |                    |  |   |
| Troubled Debt Restructurings:                                 |                    |  |   |
| Residential real estate:                                      |                    |  |   |
| Originated by Bank  | 3                  | \$ 623                                     | \$ 623                                      |
| Originated by mortgage company                                | 2                  | 779  | 777   |
| Consumer  | 9                  | 368  | 281   |
|   | Number<br>of Loans | Recorded<br>Investment                     |   |
| Troubled Debt Restructurings<br>Which Subsequently Defaulted: |                    |  |   |
| Residential real estate:                                      |                    |  |   |
| Originated by Bank  | 1                  | 62   |   |
| Consumer  | 1                  | 12   |   |
|   | Number<br>of Loans | Pre-modification<br>Recorded<br>Investment | Post-modification<br>Recorded<br>Investment |
| <b><u>Three months ended September 30, 2012</u></b>           |                    |  |   |
| Troubled Debt Restructurings:                                 |                    |  |   |
| Residential real estate:                                      |                    |  |   |
| Originated by Bank  | 4                  | \$ 375                                     | \$ 368                                      |
| Originated by mortgage company                                | 1                  | 359  | 359   |
| Consumer  | 1                  | 56   | 56  |

|   | Number<br>of Loans | Recorded<br>Investment |                        |                        |
|---|--------------------|------------------------|------------------------|------------------------|
| <b>Troubled Debt Restructurings</b>         |                    |                        |                        |                        |
| Which Subsequently Defaulted:               | None               | None                   |                        |                        |
|   |                    |                        | Pre-modification       | Post-modification      |
|   | Number<br>of Loans | Recorded<br>Investment | Recorded<br>Investment | Recorded<br>Investment |
| <u>Nine months ended September 30, 2012</u> |                    |                        |                        |                        |
| <b>Troubled Debt Restructurings:</b>        |                    |                        |                        |                        |
| <b>Residential real estate:</b>             |                    |                        |                        |                        |
| Originated by Bank                          | 9                  | \$ 2,029               | \$ 1,892               |                        |
| Originated by mortgage company              | 3                  | 978                    | 978                    |                        |
| <b>Commercial real estate:</b>              |                    |                        |                        |                        |
| Commercial                                  | 2                  | 1,315                  | 1,279                  |                        |
| Consumer                                    | 4                  | 185                    | 185                    |                        |
|   | Number<br>of Loans | Recorded<br>Investment |                        |                        |
| <b>Troubled Debt Restructurings</b>         |                    |                        |                        |                        |
| Which Subsequently Defaulted:               | None               | None                   |                        |                        |

**Table of Contents****Note 5. Reserve for Repurchased Loans and Loss Sharing Obligations**

An analysis of the reserve for repurchased loans and loss sharing obligations for the three and nine months ended September 30, 2013 and 2012 is as follows (in thousands). The reserve is included in other liabilities in the accompanying statements of financial condition.

|   | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2013                                | 2012     | 2013                               | 2012     |
| Balance at beginning of period  | \$ 1,688                            | \$ 955   | \$ 1,203                           | \$ 705   |
| Provision charged to operations   |                                     | 100      | 975                                | 350      |
| Loss on loans repurchased, settlements or payments under<br>loss sharing arrangements | (220)                               |          | (915)                              |          |
| Recoveries  |                                     |          | 205                                |          |
| Balance at end of period  | \$ 1,468                            | \$ 1,055 | \$ 1,468                           | \$ 1,055 |

The reserve for repurchased loans and loss sharing obligations was established to provide for expected losses related to repurchase requests which may be received on residential mortgage loans previously sold to investors and other loss sharing obligations. The Company prepares a comprehensive analysis of the adequacy of the reserve for repurchased loans and loss sharing obligations at each quarter-end. The reserve includes a specific loss estimate on the outstanding loan repurchase requests based on the estimated fair value of the underlying collateral modified by the likelihood of loss which is estimated based on historical experience. The reserve also includes a general loss estimate based on an estimate of loans likely to be returned for repurchase and the estimated loss on those loans. Finally, the reserve also includes an estimate of the Bank's obligation under a loss sharing arrangement with the Federal Home Loan Bank (FHLB) relating to loans sold into their Mortgage Partnership Finance (MPF) program. Under this program, the Bank and the FHLB share credit risk for loans sold. The first loss position, equal to 1% of the aggregate amount of the loan pool, is absorbed by the FHLB through a reduction in credit enhancement fees paid to the Bank. The second loss position, generally covering the next 1.5% to 4.0% of the aggregate loan pool, is absorbed by the Bank. Loan losses above the combination of these two thresholds are fully absorbed by the FHLB. In establishing the reserve, the Company considered recent and historical experience, product type and volume of loan sales and the general economic environment.

The reserve for repurchased loans and loss sharing obligations was \$1.5 million at September 30, 2013, a \$265,000 increase from December 31, 2012. The increase was due to mostly first quarter activity relating to a provision of \$100,000 for repurchase requests, an additional provision relating to loans sold to the FHLB, incurred losses relating to the FHLB loan sales, a comprehensive settlement with one investor relating to existing and anticipated loan repurchase requests, and recoveries of previously charged-off amounts. For the three months ended March 31, 2013, the Bank recognized actual losses for the first time under the MPF program of \$245,000 on two loans in a single pool. In light of these realized losses, the Bank performed an analysis of additional loss exposure and determined that additional covered losses within that loan pool were likely and recorded an additional provision of \$875,000. The analysis also revealed the actual losses of \$245,000 and the general provision of \$875,000 related to asset quality deterioration in the loan pool should have been recognized in prior periods; however these amounts were not considered material to such periods. An additional loss of \$220,000 was charged against the reserve for the three and nine months ended September 30, 2013. The Bank's maximum remaining loss exposure on all loans sold to the FHLB is \$2.4 million, although the Bank's reserve includes an estimate of expected future losses. Therefore, additional losses

will only be recognized if loan performance deteriorates beyond expectations. The reserve was reduced by a cash payment of \$450,000 as part of a comprehensive settlement with a single investor which settled seven outstanding loan repurchase requests and terminated the right of the investor to make any future claims for repurchase. The anticipated loss on this comprehensive settlement was considered in establishing the reserve at December 31, 2012. The Bank also recognized \$205,000 in recoveries relating to amounts previously charged-off. At September 30, 2013, there were two outstanding loan repurchase requests which the Company is disputing on loans with a total principal balance of \$541,000, as compared to 12 outstanding loan repurchase requests with a principal balance of \$3.6 million at December 31, 2012.

**Note 6. Deposits**

The major types of deposits at September 30, 2013 and December 31, 2012 were as follows (in thousands):

| Type of Account           | September 30, 2013 | December 31, 2012 |
|---------------------------|--------------------|-------------------|
| Non-interest-bearing      | \$ 217,061         | \$ 179,074        |
| Interest-bearing checking | 924,694            | 940,190           |
| Money market deposit      | 124,350            | 118,154           |
| Savings                   | 291,131            | 256,035           |
| Time deposits             | 211,678            | 226,218           |
| Total deposits            | \$ 1,768,914       | \$ 1,719,671      |

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Included in time deposits at September 30, 2013 and December 31, 2012, is \$56,623,000 and \$57,871,000, respectively, in deposits of \$100,000 and over.

**Note 7. Recent Accounting Pronouncements**

Accounting Standards Update No. 2013-02, *Comprehensive Income Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income* requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under Generally Accepted Accounting Principles ( GAAP ) to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under GAAP that provide additional detail about those amounts. The standard is effective prospectively for reporting periods, including interim periods, beginning after December 15, 2012. For the nine months ended September 30, 2013, the Company had a minor reclassification out of accumulated other comprehensive income and into net income which was not considered significant.

**Note 8. Fair Value Measurements**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair market measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or the most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

The Company uses valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement costs). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability and developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability and developed based on the best information available in the circumstances. In that regard, a fair value hierarchy has been established for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. Movements within the fair value hierarchy are recognized at the end of the applicable reporting period. There were no transfers between the levels of the fair value hierarchy for the three and nine months ended September 30, 2013. The fair value hierarchy is as follows:

Level 1 Inputs - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlations or other means.

Level 3 Inputs - Significant unobservable inputs that reflect an entity's own assumptions that market participants would use in pricing the assets or liabilities.

**Assets and Liabilities Measured at Fair Value**

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. Certain financial assets and financial liabilities are measured at fair value on a non-recurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).

**Table of Contents****Securities Available-For-Sale**

Securities classified as available-for-sale are reported at fair value utilizing Level 1 and Level 2 inputs. In general, fair value is based upon quoted market prices, where available. Most of the Company's investment and mortgage-backed securities, however, are fixed income instruments that are not quoted on an exchange, but are bought and sold in active markets. Prices for these instruments are obtained through third party pricing vendors or security industry sources that actively participate in the buying and selling of securities. Prices obtained from these sources include market quotations and matrix pricing. Matrix pricing is a mathematical technique used principally to value certain securities without relying exclusively on quoted prices for the specific securities, but comparing the securities to benchmark or comparable securities.

Fair value estimates are made at a point in time, based on relevant market data as well as the best information available about the security. Illiquid credit markets have resulted in inactive markets for certain of the Company's securities. As a result, there is limited observable market data for these assets. Fair value estimates for securities for which limited observable market data is available are based on judgments regarding current economic conditions, liquidity discounts, credit and interest rate risks, and other factors. These estimates involve significant uncertainties and judgments and cannot be determined with precision. As a result, such calculated fair value estimates may not be realizable in a current sale or immediate settlement of the security.

The Company utilizes third party pricing services to obtain market values for its corporate bonds. Management's policy is to obtain and review all available documentation from the third party pricing service relating to their market value determinations, including their methodology and summary of inputs. Management reviews this documentation, makes inquiries of the third party pricing service and makes a determination as to the level of the valuation inputs. Based on the Company's review of the available documentation from the third party pricing service, management concluded that Level 2 inputs were utilized. The significant observable inputs include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, benchmark securities and observations of equity and credit default swap curves related to the issuer.

**Other Real Estate Owned and Impaired Loans**

Other real estate owned, and loans measured for impairment based on the fair value of the underlying collateral are recorded at estimated fair value, less estimated selling costs of 20% and 15%, respectively. Fair value is based on independent appraisals.

The following table summarizes financial assets and financial liabilities measured at fair value as of September 30, 2013 and December 31, 2012, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

|  | Fair Value Measurements at Reporting Date Using: |                |                |                |
|--|--|----------------|----------------|----------------|
|  | Total Fair Value                                 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| <u>September 30, 2013</u>                        |  |                |                |                |
| Items measured on a recurring basis:             |  |                |                |                |
| <u>Investment securities available-for-sale:</u> |  |                |                |                |
| U.S. agency obligations                          | \$ 60,484  | \$             | \$ 60,484      | \$             |
| Equity investments                               | 8,484  | 8,484          |                |                |

Items measured on a non-recurring basis:

|  |        |        |
|--|--------|--------|
| Other real estate owned  | 4,259  | 4,259  |
| Loans measured for impairment based on the fair value of the underlying collateral | 11,391 | 11,391 |

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|  | Fair Value Measurements at Reporting Date Using: |                |                |                |
|--|--|----------------|----------------|----------------|
|  | Total Fair Value                                 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| <b><u>December 31, 2012</u></b>  |  |                |                |                |
| Items measured on a recurring basis:   |  |                |                |                |
| Investment securities available-for-sale:  |  |                |                |                |
| U.S. agency obligations  | \$ 139,050                                       | \$             | \$ 139,050     | \$             |
| State and municipal obligations  | 25,780   |                | 25,780         |                |
| Corporate debt securities  | 43,470   |                | 43,470         |                |
| Equity investments   | 5,293  | 5,293          |                |                |
| Mortgage-backed securities available-for-sale                                      | 333,857  |                | 333,857        |                |
| Items measured on a non-recurring basis:   |  |                |                |                |
| Other real estate owned  | 3,210  |                |                | 3,210          |
| Loans measured for impairment based on the fair value of the underlying collateral | 12,033   |                |                | 12,033         |
| <b><u>Assets and Liabilities Disclosed at Fair Value</u></b>                       |  |                |                |                |

A description of the valuation methodologies used for assets and liabilities disclosed at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below.

**Cash and Due from Banks**

For cash and due from banks, the carrying amount approximates fair value.

**Securities Held-to-Maturity**

Securities classified as held-to-maturity are carried at amortized cost, as the Company has the positive intent and ability to hold these securities to maturity. The Company determines the fair value of the securities utilizing Level 1 and Level 2 inputs. In general, fair value is based upon quoted market prices, where available. Most of the Company's investment and mortgage-backed securities, however, are fixed income instruments that are not quoted on an exchange, but are bought and sold in active markets. Prices for these instruments are obtained through third party pricing vendors or security industry sources that actively participate in the buying and selling of securities. Prices obtained from these sources include market quotations and matrix pricing. Matrix pricing is a mathematical technique used principally to value certain securities without relying exclusively on quoted prices for the specific securities, but comparing the securities to benchmark or comparable securities.

Fair value estimates are made at a point in time, based on relevant market data as well as the best information available about the security. Illiquid credit markets have resulted in inactive markets for certain of the Company's securities. As a result, there is limited observable market data for these assets. Fair value estimates for securities for which limited observable market data is available are based on judgments regarding current economic conditions, liquidity discounts, credit and interest rate risks, and other factors. These estimates involve significant uncertainties and judgments and cannot be determined with precision. As a result, such calculated fair value estimates may not be realizable in a current sale or immediate settlement of the security.

The Company utilizes third party pricing services to obtain market values for its corporate bonds. Management's policy is to obtain and review all available documentation from the third party pricing service relating to their market value determinations, including their methodology and summary of inputs. Management reviews this documentation, makes inquiries of the third party pricing service and makes a determination as to the level of the valuation inputs.

Based on the Company's review of the available documentation from the third party pricing service, management concluded that Level 2 inputs were utilized. The significant observable inputs include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, benchmark securities and observations of equity and credit default swap curves related to the issuer.

#### Federal Home Loan Bank of New York Stock

The fair value for Federal Home Loan Bank of New York stock is its carrying value since this is the amount for which it could be redeemed. There is no active market for this stock and the Company is required to maintain a minimum investment based upon the outstanding balance of mortgage related assets and outstanding borrowings.

#### Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as residential mortgage, construction, consumer and commercial. Each loan category is further segmented into fixed and adjustable rate interest terms.

Fair value of performing and non-performing loans was estimated by discounting the future cash flows, net of estimated prepayments, at a rate for which similar loans would be originated to new borrowers with similar terms. Fair values estimated in this manner do not fully incorporate an exit price approach to fair value, but instead are based on a comparison to current market rates for comparable loans.

**Table of Contents****Deposits Other than Time Deposits**

The fair value of deposits with no stated maturity, such as non-interest-bearing demand deposits, savings, and interest-bearing checking accounts and money market accounts are, by definition, equal to the amount payable on demand. The related insensitivity of the majority of these deposits to interest rate changes creates a significant inherent value which is not reflected in the fair value reported.

**Time Deposits**

The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

**Securities Sold Under Agreements to Repurchase with Retail Customers**

Fair value approximates the carrying amount as these borrowings are payable on demand and the interest rate adjusts monthly.

**Borrowed Funds**

Fair value estimates are based on discounting contractual cash flows using rates which approximate the rates offered for borrowings of similar remaining maturities.

The book value and estimated fair value of the Bank's significant financial instruments not recorded at fair value as of September 30, 2013 and December 31, 2012 are presented in the following tables (in thousands):

|  | Book Value | Fair Value Measurements at Reporting Date Using: |                |                |
|--|------------|--|----------------|----------------|
|  |            | Level 1 Inputs                                   | Level 2 Inputs | Level 3 Inputs |
| <b><u>September 30, 2013</u></b>                                     |            |  |                |                |
| <b>Financial Assets:</b>   |            |  |                |                |
| Cash and due from banks  | \$ 44,055  | \$ 44,055  | \$             | \$             |
| Securities held-to-maturity  | 514,022    |  | 517,173        |                |
| Federal Home Loan Bank of New York stock                             | 15,211     |  |                | 15,211         |
| Loans receivable and mortgage loans held for sale                    | 1,524,991  |  |                | 1,541,323      |
| <b>Financial Liabilities:</b>  |            |  |                |                |
| Deposits other than time deposits                                    | 1,557,236  |  | 1,557,236      |                |
| Time deposits  | 211,678    |  | 214,623        |                |
| Securities sold under agreements to repurchase with retail customers | 69,951     | 69,951   |                |                |
| Federal Home Loan Bank advances and other borrowings                 | 216,500    |  | 219,370        |                |

Fair Value Measurements at Reporting Date Using:

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|  | Book Value | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|--|------------|----------------|----------------|----------------|
| <u>December 31, 2012</u>   |            |                |                |                |
| Financial Assets:  |            |                |                |                |
| Cash and due from banks  | \$ 62,544  | \$ 62,544      | \$             | \$             |
| Federal Home Loan Bank of New York stock                             | 17,061     |                |                | 17,061         |
| Loans receivable and mortgage loans held for sale                    | 1,529,946  |                |                | 1,572,291      |
| Financial Liabilities:   |            |                |                |                |
| Deposits other than time deposits                                    | 1,493,453  |                | 1,493,453      |                |
| Time deposits  | 226,218    |                | 231,445        |                |
| Securities sold under agreements to repurchase with retail customers | 60,791     | 60,791         |                |                |
| Federal Home Loan Bank advances and other borrowings                 | 252,500    |                | 258,577        |                |

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because a limited market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other significant unobservable inputs. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include deferred tax assets, and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

**Note 9. Subsequent Events**

Subsequent to quarter-end, the Company made the strategic decision to prepay \$159.0 million of Federal Home Loan Bank advances with a weighted average cost of 2.31% and a weighted average term to maturity of 16 months. The pre-tax prepayment fee on these borrowings was \$4.3 million, or \$0.16 per diluted share, which will be reflected in the fourth quarter's reported earnings. The prepayment was initially funded by short-term advances, which the Company expects to supplement with deposit growth. Over the next year, the short-term advances will gradually be extended into longer-term liabilities. The transaction will improve net interest income and margin in future periods and, when fully implemented, will reduce the Company's sensitivity to further interest rate increases.

The Company is focused on growing revenues in commercial lending, trust and asset management, and Bankcard services. In order to fund the required investment in these areas, the Bank reviewed branch expenses and decided to consolidate two branches into newer, in-market OceanFirst Bank facilities. The consolidation is scheduled to occur in the fourth quarter and is expected to result in a non-recurring charge of \$630,000.

**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

The Company is not engaged in any legal proceedings of a material nature at the present time. From time to time, the Company is a party to routine legal proceedings within the normal course of business. Such routine legal proceedings in the aggregate are believed by management to be immaterial to the Company's financial condition or results of operations.

**Item 1A. Risk Factors**

For a summary of risk factors relevant to the Company, see Part I, Item 1A, "Risk Factors," in the 2012 Form 10-K. There were no material changes to risk factors relevant to the Company's operations since December 31, 2012.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On November 27, 2012, the Company announced its intention to repurchase up to 901,002 shares or 5% of its outstanding common stock. Information regarding the Company's common stock repurchases for the three month period ended September 30, 2013 is as follows:

| Period | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per Share | Total Number<br>of<br>Shares Purchased as<br>Part of<br>Publicly | Maximum<br>Number of<br>Shares<br>that May Yet<br>Be |
|--------|---|------------------------------------|--|--|
|--------|---|------------------------------------|--|--|

|   |         |       | Announced Plans or<br>Programs | Purchased Under the<br>Plans or<br>Programs |
|---|---------|-------|--------------------------------|---|
| July 1, 2013 through July 31, 2013              | \$      |       |                                | 519,823                                     |
| August 1, 2013 through<br>August 31, 2013       |         |       |                                | 519,823                                     |
| September 1, 2013 through<br>September 30, 2013 | 218,057 | 16.49 | 218,057                        | 301,766                                     |

**Item 3. Defaults Upon Senior Securities**

Not Applicable

**Item 4. Mine Safety Disclosures**

Not Applicable

**Item 5. Other Information**

Not Applicable

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**Item 6. Exhibits**

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
- 32.0 Certification pursuant to 18 U.S.C. Section 1350 as added by Section 906 of the Sarbanes-Oxley Act of 2002
- 101.0 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Condition, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to Consolidated Financial Statements.\*

\* Pursuant to SEC rules, this exhibit will not be deemed filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liability of that section.

(1) Incorporated herein by reference from Exhibit to Form 8-K filed on February 28, 2013.

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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.

OceanFirst Financial Corp.

Registrant

DATE: November 8, 2013

/s/ John R. Garbarino  
John R. Garbarino  
Chairman of the Board and Chief Executive Officer

DATE: November 8, 2013

/s/ Michael J. Fitzpatrick  
Michael J. Fitzpatrick  
Executive Vice President and Chief Financial Officer



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## Exhibit Index

| Exhibit | Description  | Page |
|---------|--|------|
| 31.1    | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   | 39   |
| 31.2    | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   | 40   |
| 32.0    | Certification pursuant to 18 U.S.C. Section 1350 as added by Section 906 of the Sarbanes-Oxley Act of 2002   | 41   |
| 101.0   | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Condition, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to Consolidated Financial Statements.* |      |

\* Pursuant to SEC rules, this exhibit will not be deemed filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liability of that section.