FLAGSTAR BANCORP INC
Form 10-Q
August 05, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

OR

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

Commission File Number: 001-16577

(Exact name of registrant as specified in its charter)

Michigan	**38-3150651**
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)
5151 Corporate Drive, Troy, Michigan	**48098-2639**
(Address of principal executive offices)	(Zip code)

(248) 312-2000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of August 4, 2008, 72,336,848 shares of the registrant s common stock, $0.01 par value, were issued and outstanding.

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FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of Flagstar Bancorp, Inc. (Flagstar or the Company) and these statements are subject to risk and uncertainty. Forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, include those using words or phrases such as believes, expects, anticipates, plans, trend, objective, continue, remain, pattern or similar expressions or future or conditiona as will, would, should, could, might, can, may or similar expressions.

There are a number of important factors that could cause future results to differ materially from historical performance and these forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed under the heading Risk Factors in Part I, Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2007 and Part II, Item 1A of this Quarterly Report on Form 10-Q, including: (1) general business, economic and political conditions may significantly affect our earnings; (2) if we cannot effectively manage the impact of the volatility of interest rates, our earnings could be adversely affected; (3) the value of our mortgage servicing rights could decline with reduction in interest rates; (4) gains on mortgage servicing rights may be difficult to realize due to disruption in the capital markets; (5) we use estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; (6) current and further deterioration in the housing and commercial real estate markets may lead to increased loss severities and further worsening of delinquencies and non-performing assets in our loan portfolios. Consequently, our allowance for loan losses may not be adequate to cover actual losses, and we may be required to materially increase our reserves; (7) our secondary market reserve for losses could be insufficient; (8) our home lending profitability could be significantly reduced if we are not able to resell mortgages; (9) our commercial real estate and commercial business loan portfolios carry heightened credit risk; (10) we have substantial risks in connection with securitizations and loan sales; (11) our ability to borrow funds, maintain or increase deposits or raise capital could be limited, which could adversely affect our liquidity and earnings; (12) we may be required to raise capital at terms that are materially adverse to our stockholders; (13) our holding company is dependent on the Bank for funding of obligations and dividends; (14) we may not be able to replace key members of senior management or attract and retain qualified relationship managers in the future; (15) the network and computer systems on which we depend could fail or experience a security breach; (16) our business is highly regulated; (17) our business has volatile earnings because it operates based on a multi-year cycle; (18) our loans are geographically concentrated in only a few states; (19) a larger percentage or our loans are collateralized by real estate, and an adverse change in the real estate market may result in losses and adversely affect our portfolio; (20) a significant part of our business strategy involves adding new branch locations, and our failure to grow may adversely affect our business, prospects, and results of operations and financial condition; (21) we are subject to heightened regulatory scrutiny with respect to bank secrecy and anti-money laundering statutes and regulations; (22) certain hedging strategies that we use to manage our investment in mortgage servicing rights may be ineffective to offset any adverse changes in the fair value of these assets due to changes in interest rate; and (23) we depend on our institutional counterparties to provide services that are critical to our business. If one or more of our institutional counterparties defaults on its obligations to us or becomes insolvent, it could materially adversely affect our earnings, liquidity, capital position and financial condition.

The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

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FOR THE QUARTER ENDED JUNE 30, 2008
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

The unaudited condensed consolidated financial statements of the Company are as follows:

Consolidated Statements of Financial Condition — June 30, 2008 (unaudited) and December 31, 2007.

Unaudited Consolidated Statements of Earnings — For the three and six months ended June 30, 2008 and 2007.

Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss) — For the six months ended June 30, 2008 (unaudited) and for the year ended December 31, 2007.

Unaudited Consolidated Statements of Cash Flows — For the six months ended June 30, 2008 and 2007.

Unaudited Notes to Consolidated Financial Statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Financial Condition
(In thousands, except for share data)

	At June 30, 2008 (Unaudited)	At December 31, 2007
Assets		
Cash and cash items	$ 134,852	$ 129,992
Interest-bearing deposits	37,835	210,177
Cash and cash equivalents	172,687	340,169
Securities classified as trading	33,782	13,703
Securities classified as available for sale	978,033	1,308,608
Mortgage-backed securities held to maturity (fair value $1.3 billion at December 31, 2007)		1,255,431
Other investments	29,756	26,813
Loans available for sale	2,706,372	3,511,310
Loans held for investment	9,091,262	8,134,397
Less: allowance for loan losses	(154,000)	(104,000)
Loans held for investment, net	8,937,262	8,030,397
Total interest-earning assets	12,723,040	14,356,439
Accrued interest receivable	51,470	57,888
Repossessed assets, net	118,582	95,074
Federal Home Loan Bank stock	373,443	348,944
Premises and equipment, net	244,627	237,652
Mortgage servicing rights at fair value	661,819	
Mortgage servicing rights, net	10,566	413,986
Other assets	287,594	151,120
Total assets	$ 14,605,993	$ 15,791,095
Liabilities and Stockholders Equity Liabilities		
Deposits	$ 7,478,188	$ 8,236,744
Federal Home Loan Bank advances	5,736,000	6,301,000
Security repurchase agreements	108,000	108,000
Long term debt	248,685	248,685
Total interest-bearing liabilities	13,570,873	14,894,429
Accrued interest payable	42,753	47,070
Secondary market reserve	28,000	27,600
Other liabilities	162,603	129,018
Total liabilities	13,804,229	15,098,117
Commitments and Contingencies		
Stockholders Equity		

Preferred stock $0.01 par value, 25,000,000 shares authorized; 47,982 shares of mandatory convertible non-cumulative perpetual preferred stock, series A with a liquidation preference of $1,000 per share issued at June 30, 2008	1		
Common stock $.01 par value, 150,000,000 shares authorized; 72,336,848 and 63,656,979 shares issued, and 72,336,848 and 60,270,624 shares outstanding at June 30, 2008 and December 31, 2007, respectively	723		637
Additional paid in capital	118,413		64,350
Accumulated other comprehensive loss	(32,102)		(11,495)
Retained earnings	714,729		681,165
Treasury stock, at cost, no shares at June 30, 2008, and 3,386,355 shares at December 31, 2007			(41,679)
Total stockholders equity	801,764		692,978
Total liabilities and stockholders equity	$ 14,605,993	$	15,791,095

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Earnings
(In thousands, except per share data)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
	(Unaudited)			
Interest Income				
Loans	$ 177,582	$ 189,958	$ 353,876	$ 377,208
Mortgage-backed securities held to maturity		13,768	15,576	28,385
Securities available for sale	21,171	13,524	36,761	27,122
Interest-bearing deposits	1,376	2,674	4,145	6,176
Other	435	2,540	1,059	4,142
Total interest income	200,564	222,464	411,417	443,033
Interest Expense				
Deposits	70,817	86,038	154,867	171,064
FHLB advances	63,327	64,882	127,885	132,734
Security repurchase agreements	1,207	18,041	4,362	30,434
Other	3,814	2,462	8,106	4,909
Total interest expense	139,165	171,423	295,220	339,141
Net interest income	61,399	51,041	116,197	103,892
Provision for loan losses	43,833	11,452	78,096	19,745
Net interest income after provision for loan losses	17,566	39,589	38,101	84,147
Non-Interest Income				
Loan fees and charges	617	1,415	1,501	2,644
Deposit fees and charges	6,815	5,710	12,846	10,688
Loan administration	37,370	1,985	20,324	4,168
Net gain on loan sales	43,826	28,144	107,252	53,298
Net (loss) gain on sales of mortgage servicing rights	(834)	5,610	(547)	5,725
Net gain on sales of securities available for sale	4,869		4,869	729
Loss on trading securities	(4,104)		(13,586)	
Other fees and charges	11,718	13,456	20,293	18,494
Total non-interest income	100,277	56,320	152,952	95,746
Non-Interest Expense				
Compensation and benefits	52,084	39,150	106,077	78,642
Occupancy and equipment	20,437	17,014	40,258	33,782
Communication	1,801	2,330	3,586	3,404
Other taxes	384	(10)	1,276	(583)
General and administrative	19,030	13,750	31,708	28,795

Total non-interest expense	93,736	72,234	182,905	144,040
Earnings before federal income taxes	24,107	23,675	8,148	35,853
Provision for federal income taxes	8,361	8,544	3,002	12,963
Net Earnings	$ 15,746	$ 15,131	$ 5,146	$ 22,890
Earnings per share				
Basic	$ 0.24	$ 0.25	$ 0.08	$ 0.37
Diluted	$ 0.22	$ 0.25	$ 0.08	$ 0.37

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss)
(In thousands, except per share data)

	Preferred Stock	Common Stock	Additional Paid in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholders Equity
Balance at January 1, 2007	$	$ 636	$ 63,223	$ 5,182	$ 743,193	$	$ 812,234
Net loss					(39,225)		(39,225)
Reclassification of gain on swap extinguishment				(101)			(101)
Change in net unrealized loss on swaps used in cash flow hedges				(3,957)			(3,957)
Change in net unrealized loss on securities available for sale				(12,619)			(12,619)
Total comprehensive loss							(55,902)
Adjustment to initially apply FIN 48					(1,428)		(1,428)
Stock options exercised		1	69				70
Stock-based compensation			1,083				1,083
Tax effect from stock-based compensation			(25)				(25)
Purchase of treasury stock						(41,705)	(41,705)
Issuance of treasury stock						26	26
Dividends paid ($0.35 per share)					(21,375)		(21,375)
Balance at December 31, 2007		637	64,350	(11,495)	681,165	(41,679)	692,978
(Unaudited)							
Net earnings					5,146		5,146
Reclassification of gain on dedesignation of				(236)			(236)

swaps used in cash flow hedges							
Change in net unrealized loss on securities available for sale				(20,371)			(20,371)
Total comprehensive loss							(15,461)
Cumulative effect adjustment due to change of accounting for residential mortgage servicing rights					28,418		28,418
Issuance of preferred stock	1		45,796				45,797
Issuance of common stock		86	8,480				8,566
Issuance of treasury stock						41,092	41,092
Restricted stock issued			(587)			587	
Stock options exercised			77				77
Stock-based compensation			502				502
Tax effect from stock-based compensation			(205)				(205)
Balance at June 30, 2008	$ 1	$ 723	$ 118,413	$ (32,102)	$ 714,729	$	$ 801,764

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows
(In thousands)

	For the Six Months Ended June 30,	
	2008	2007
	(Unaudited)	
Operating Activities		
Net earnings	$ 5,146	$ 22,890
Adjustments to net earnings to net cash used in operating activities		
Provision for loan losses	78,096	19,745
Depreciation	11,663	12,730
Amortization of MSRs	1,348	33,417
Decrease in valuation allowance in mortgage servicing rights	(55)	(408)
Loss on fair value of residential mortgage servicing rights, net of hedging gains (losses)	44,064	
Stock-based compensation expense	502	725
Loss on interest rate swaps	627	
Net loss (gain) on the sale of assets	82	(1,777)
Net gain on loan sales	(107,252)	(53,298)
Net loss (gain) on sales of mortgage servicing rights	547	(5,725)
Net gain on securities classified as available for sale	(4,869)	(729)
Unrealized loss on trading securities	13,586	
Proceeds from sales and securitization of loans available for sale	12,242,515	10,433,710
Origination and repurchase of mortgage loans available for sale, net of principal repayments	(13,593,576)	(12,477,316)
Decrease (increase) in accrued interest receivable	6,418	(3,386)
Increase in other assets	(169,183)	(25,438)
(Decrease) increase in accrued interest payable	(4,317)	1,511
Net tax effect for stock grants issued	205	43
Decrease in federal income taxes payable	(34,161)	(1,412)
Decrease in payable for securities purchased		(249,694)
Increase (decrease) in other liabilities	22,587	(2,813)
Net cash used in operating activities	(1,486,027)	(2,297,225)
Investing Activities		
Net change in other investments	(2,942)	(198)
Repayment of mortgage-backed securities held to maturity	90,846	178,823
Proceeds from sale of investment securities available for sale	899,855	171,441
Repayment (purchase) of investment securities available for sale	104,090	(202,794)
Proceeds from sales of portfolio loans	1,265,066	693,283
Origination of portfolio loans, net of principal repayments	182,688	526,147
Purchase of Federal Home Loan Bank stock	(24,499)	(51,457)
Investment in unconsolidated subsidiary		774
Proceeds from the disposition of repossessed assets	41,419	47,927
Acquisitions of premises and equipment, net of proceeds	(17,305)	(14,793)
Proceeds from the sale of mortgage servicing rights		33,459

Net cash provided by investing activities	2,539,218	1,382,612
Financing Activities		
Net (decrease) increase in deposit accounts	(758,556)	74,322
Net increase in security repurchase agreements		714,612
Net (decrease) increase in Federal Home Loan Bank advances	(565,000)	122,055
Issuance of junior subordinated debt		25,000
Net (disbursement) receipt of payments of loans serviced for others	(10,029)	6,226
Net receipt of escrow payments	17,585	24,298
Proceeds from the exercise of stock options	77	(146)
Net tax effect of stock grants issued	(205)	(43)
Issuance of preferred stock	45,797	
Issuance of common stock	8,566	
Issuance of treasury stock	41,092	
Dividends paid to stockholders		(12,334)
Purchase of treasury stock		(41,705)
Net cash (used in) provided by financing activities	(1,220,673)	912,285
Net decrease in cash and cash equivalents	(167,482)	(2,328)
Beginning cash and cash equivalents	340,169	277,236
Ending cash and cash equivalents	$ 172,687	$ 274,908

	For the Six Months Ended June 30,	
	2008	2007
	(Unaudited)	
Supplemental disclosure of cash flow information:		
Loans held for investment transferred to repossessed assets	$ 93,106	$ 56,315
Total interest payments made on deposits and other borrowings	$ 299,537	$ 339,634
Federal income taxes paid	$ 5,808	$
Reclassification of mortgage loans originated for portfolio to mortgage loans available for sale	$	$ 167,943
Reclassification of mortgage loans originated available for sale then transferred to portfolio loans	$ 1,255,416	$ 693,283
Mortgage servicing rights resulting from sale or securitization of loans	$ 203,838	$ 154,000
Reclassification of mortgage backed securities held to maturity to securities available for sale	$ 1,163,681	$
Retention of residual interests in securitization transactions	$	$ 29,398

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Notes to Consolidated Financial Statements
(Unaudited)

Note 1. Nature of Business

Flagstar Bancorp, Inc. (Flagstar or the Company), is the holding company for Flagstar Bank, FSB (the Bank), a federally chartered stock savings bank founded in 1987. With $14.6 billion in assets at June 30, 2008, Flagstar is the largest financial institution headquartered in Michigan.

The Company s principal business is obtaining funds in the form of deposits and wholesale borrowings and investing those funds in single-family mortgages and other types of loans. Its primary lending activity is the acquisition or origination of single-family mortgage loans. The Company also originates consumer loans, commercial real estate loans, and non-real estate commercial loans and it services a significant volume of residential mortgage loans for others.

The Company sells or securitizes most of the mortgage loans that it originates and generally retains the right to service the mortgage loans that it sells. These mortgage-servicing rights (MSRs) have occasionally been sold by the Company in transactions separate from the sale of the underlying mortgages. The Company may also retain a portion of its loan production on its statement of financial condition as loans held for investment in order to enhance the Company s leverage ability and receive the interest spread between earning assets and paying liabilities.

The Bank is a member of the Federal Home Loan Bank of Indianapolis (FHLB) and is subject to regulation, examination and supervision by the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). The Bank s deposits are insured by the FDIC up to applicable limits.

Note 2. Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of the Company and its consolidated subsidiaries. All significant intercompany balances and transactions have been eliminated. In accordance with current accounting principles, the Company s trust subsidiaries are not consolidated. In addition, certain prior period amounts have been reclassified to conform to the current period presentation.

The unaudited consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles for interim information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (SEC). Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America (U.S. GAAP) for complete financial statements. The accompanying interim financial statements are unaudited; however, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the three and six month periods ended June 30, 2008, are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. For further information, you should refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007. The Form 10-K can be found on the Company s Investor Relations web page, at **www.flagstar.com**, and on the website of the SEC, at **www.sec.gov**.

Note 3. Recent Accounting Developments

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements.* SFAS 157 defines the term fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP, and expands disclosures about fair value measurements. SFAS 157 clarifies that the exchange price is the price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. SFAS 157 emphasizes that fair value is a market-based measurement and not an entity-specific measurement. It also establishes a hierarchy used in such measurement and expands the required disclosures of assets and liabilities measured at fair value. The Company adopted SFAS 157 as of January 1, 2008. See Note 4, Fair Value Accounting for further information.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities.* SFAS 159 permits entities to choose to measure financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The decision to elect the fair value option may be applied

instrument by instrument, is irrevocable and must be applied to the entire instrument and not to specified risks, specific cash flows or portions of that instrument. An entity is restricted in choosing the dates to elect the fair value option for an eligible item. The Company adopted SFAS 159 effective January 1, 2008. See Note 4, Fair Value Accounting for further information.

In November 2007, the FASB issued SFAS 160, *Non-controlling Interest in Consolidated Financial Statements an amendment to ARB No. 51.* SFAS 160 changes the way consolidated net earnings are presented. The new standard requires consolidated net earnings to be reported at amounts attributable to both the parent and the non-controlling interest on the face of the consolidated statement of earnings. The adoption of this statement will result in more transparent reporting of the net earnings attributable to non-controlling interests. The statement establishes a single method of accounting for changes in a parent s ownership interest in a subsidiary which does not result in deconsolidation. The statement also requires that a parent recognize a gain or loss in net earnings when a subsidiary is deconsolidated. The adoption of SFAS 160 is effective for the Company on January 1, 2009. Management does not expect that the adoption of this statement will have a material impact on the Company s consolidated financial condition, results of operation or liquidity.

In November 2007, the SEC issued Staff Accounting Bulletin 109 (SAB 109) regarding the written loan commitments that are accounted for at fair value through earnings under generally accepted accounting principles. SAB 109 supersedes SAB 105 and expresses the current view of the SEC staff that, consistent with the guidance in SFAS 156, "*Accounting for Servicing of Financial Assets* and SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, the expected net future cash flows related to the associated servicing of the loans should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The adoption of SAB 109 is effective on a prospective basis for the Company s derivative loan commitments issued or modified on or after January 1, 2008. The effect of this change resulted in an increase in the Company s gain on loan sales by approximately $5.9 million during the three month period ended June 30, 2008.

In December 2007, the SEC issued Staff Accounting Bulletin 110 (SAB 110). SAB 110 expresses the views of the SEC regarding the use of a simplified method in developing an estimate of the expected term of plain vanilla share options as discussed in SAB 107 and issued under SFAS 123 (revised 2004), *Share-Based Payment.* The SEC indicated in SAB 107 that it would accept a company s decision to use the simplified method, regardless of whether the company had sufficient information to make more refined estimates of expected term. Under SAB 107, the SEC had believed detailed information about employee exercise behavior would be readily available and therefore would not expect companies to use the simplified method for share option grants after December 31, 2007. SAB 110 states that the SEC will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Company does not utilize the simplified method, and therefore management does not expect that this pronouncement will have an impact on the Company s consolidated financial condition, results of operation or liquidity.

In March 2008, the FASB issued SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133.* SFAS 161 requires enhanced disclosures about an entity s derivative and hedging activities and thereby improves on the transparency of financial reporting. In adopting SFAS 161, entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial positions, financial performance and cash flows. Because this pronouncement affects only disclosures, this pronouncement will not have an impact on the Company s consolidated financial condition, results of operation or liquidity. The adoption of SFAS 161 is effective for fiscal years beginning after November 15, 2008, with early adoption permitted. The Company does not expect to elect early adoption of SFAS 161.

In May 2008, the FASB issued SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles.* SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of non-governmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The adoption of SFAS 162 will be effective 60 days following SEC approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. Management does not expect that the adoption of this statement will have a material impact of this Company s financial condition, results of operation or liquidity.

In May 2008, the FASB issued SFAS 163, *Accounting for Financial Guarantee Insurance Contracts an interpretation of FASB Statement No. 60.* SFAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default when there is evidence that credit deterioration has occurred in an insured financial obligation. The statement also clarifies how SFAS 60 applies to financial guarantee insurance contracts by insurance enterprises. The statement also requires expanded disclosures about financial guarantee insurance contracts. The adoption of SFAS 163 will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods of those years, except for some disclosures about the risk-management activities. Management does not expect that this statement will have an impact on the Company s financial condition, results of operation or liquidity.

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Note 4. Fair Value Accounting

On January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements* and SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 was issued to establish a uniform definition of fair value. The definition of fair value under SFAS 157 is market-based as opposed to company-specific and includes the following:

- Defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in either case through an orderly transaction between market participants at a measurement date, and establishes a framework for measuring fair value;

- Establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date;

- Nullifies the guidance in EITF 02-3, which required the deferral of profit at inception of a transaction involving a derivative financial instrument in the absence of observable data supporting the valuation technique;

- Eliminates large position discounts for financial instruments quoted in active markets and requires consideration of the company s creditworthiness when valuing liabilities; and

- Expands disclosures about instruments that are measured at fair value.

SFAS 159 provides an option to elect fair value as an alternative measurement for selected financial assets, financial liabilities, unrecognized Company commitments and written loan commitments not previously recorded at fair value. In accordance with the provisions of SFAS 159, the Company, as of January 1, 2008, elected the fair value option for certain non-investment grade residual securities from private-label securitizations. The Company elected fair value on these residual securities and reclassified these investments as securities trading to provide consistency in the accounting for the Company s residual interests. The Company had recognized a permanent impairment on these residual securities as of December 31, 2007, thereby reducing the carrying value to fair value at that time. Thus, the fair value election had no impact on opening retained earnings. The decrease in fair value for the three and six months ended June 30, 2008 was $3.0 million and $10.5 million, respectively, before taxes, which is included within the total loss on trading securities reported in the Company s Consolidated Statement of Earnings.

Effective January 1, 2008, the Company elected the fair value measurement method for residential MSRs under SFAS 156 *Accounting for Servicing of Financial Assets an amendment of FASB 140.* Upon election, the carrying value of the residential MSRs was increased to fair value by recognizing a cumulative effect adjustment to retained earnings of $43.7 million before tax, or $28.4 million after tax. Management elected the fair value measurement method of accounting for residential MSRs to be consistent with the fair value accounting method required for its risk management strategy to hedge the fair value of these assets. Changes in the fair value of residential MSRs, as well as changes in fair value of the related derivative instruments, are recognized each period within loan administration income (loss) on the consolidated statement of earnings.

Determination of Fair Value

The following is a description of the Company s valuation methodologies for assets measured at fair value which have been applied to all assets carried at fair value, whether as a result of the adoption of SFAS 159, SFAS 156 or previously carried at fair value.

The Company has an established process for determining fair values. Fair value is based upon quoted market prices, where available. If listed prices or quotes are not available, fair value is based upon internally developed models that use primarily market-based or independently-sourced market parameters, including interest rate yield curves and option volatilities. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments include amounts to reflect counterparty credit quality, creditworthiness, liquidity and unobservable parameters that are applied consistently over time. Any changes to the valuation methodology are reviewed by management to determine appropriateness of the changes. As markets develop and the pricing for certain

products becomes more transparent, the Company expects to continue to refine its valuation methodologies.

The methods described above may produce a fair value estimate that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in different estimates of fair values of the same financial instruments at the reporting date.

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Valuation Hierarchy

SFAS 157 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy favors the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows.

Level 1 Fair value is based upon quoted prices (unadjusted) for identical assets or liabilities in active markets in which the Company can participate.

Level 2 Fair value is based upon quoted prices for similar (i.e., not identical) assets and liabilities in active markets, and other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Fair value is based upon financial models using primarily unobservable inputs.

A financial instrument s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following is a description of the valuation methodologies used by the Company for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Assets

Securities classified as trading. These securities are non-investment grade residual securities that arose from private-label securitizations of the Company in 2005, 2006 and 2007. These non-investment grade residual securities do not trade in an active, open market with readily observable prices and are therefore classified within the Level 3 valuation hierarchy. Accordingly, the fair value of residual securities is determined by discounting estimated net future cash flows using expected prepayment rates and discount rates that approximate current market rates. Estimated net future cash flows include assumptions related to expected credit losses on these securities. The Company maintains a model that evaluates the default rate and severity of loss on the residual securities collateral, considering such factors as loss experience, delinquencies, loan-to-value ratios, borrower credit scores and property type.

Securities classified as available for sale. Where quoted prices for securities are available in an active market, those securities are classified within Level 1 of the valuation hierarchy. If such quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. Examples of securities with similar characteristics, which would generally be classified within Level 2 of the valuation hierarchy, include certain AAA-rated U.S. government sponsored agency securities. Due to illiquidity in the markets, the Company determined the fair value of certain AAA-rated non-agency securities using internal valuation models and therefore classified them within the Level 3 valuation hierarchy as these models utilize significant inputs which are unobservable.

Other Investments. Other investments are primarily comprised of various mutual fund holdings. These mutual funds trade in an active market and quoted prices are available. Other investments are classified within Level 1 of the valuation hierarchy.

Loans held for investment. The Company does not record these loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2008, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as a nonrecurring Level 2 valuation.

Repossessed assets. Loans on which the underlying collateral has been repossessed are adjusted to fair value upon transfer to repossessed assets. Subsequently, repossessed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the repossessed asset as a nonrecurring Level 2 valuation.

Mortgage Servicing Rights. The Company has obligations to service residential first mortgage loans and consumer loans (i.e. home equity lines of credit (HELOCs) and second mortgage loans obtained through private-label securitization

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transactions). Effective January 1, 2008, the Company elected the fair value measurement method for residential MSRs under SFAS 156. Upon this election, residential MSRs began to be accounted for at fair value on a recurring basis. Consumer servicing assets are carried at amortized cost and are periodically evaluated for impairment.

Residential Mortgage Servicing Rights. The current market for residential mortgage servicing rights is not sufficiently liquid to provide participants with quoted market prices. Therefore, the Company uses an option-adjusted spread valuation approach to determine the fair value of residential MSRs. This approach consists of projecting servicing cash flows under multiple interest rate scenarios and discounting these cash flows using risk-adjusted discount rates. The key assumptions used in the valuation of residential MSRs include mortgage prepayment speeds and discount rates. Management periodically obtains third-party valuations of the residential MSR portfolio to assess the reasonableness of the fair value calculated by its internal valuation model. Due to the nature of the valuation inputs, residential MSRs are classified within Level 3 of the valuation hierarchy. See Note 9, Mortgage Servicing Rights for the key assumptions used in the residential MSR valuation process.

Consumer Servicing Assets. Consumer servicing assets are subject to periodic impairment testing. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and a discount rate determined by management, is used in the completion of impairment testing. If the valuation model reflects a value less than the carrying value, consumer servicing assets are adjusted to fair value through a valuation allowance as determined by the model. As such, the Company classifies consumer servicing assets subject to nonrecurring fair value adjustments as Level 3 valuations.

Derivative Financial Instruments. Certain classes of derivative contracts are listed on an exchange and are actively traded, and are therefore classified within Level 1 of the valuation hierarchy. These include U.S. Treasury futures, U.S. Treasury options and interest rate swaps. The Company s forward loan commitments may be valued based on quoted prices for similar assets in an active market with inputs that are observable and are classified within Level 2 of the valuation hierarchy. Rate lock commitments are valued using internal models with significant unobservable market parameters and therefore are classified within Level 3 of the valuation hierarchy.

Assets measured at fair value on a recurring basis

The following table presents the financial instruments carried at fair value as of June 30, 2008, by caption on the Consolidated Statement of Financial Condition and by SFAS 157 valuation hierarchy (as described above) (dollars in thousands):

	Level 1	Level 2	Level 3	Total carrying value in the Consolidated Statement of Financial Condition
Securities classified as trading:				
Residual interests	$	$	$ 33,782	$ 33,782
Securities classified as available for sale		225,519	752,514	978,033
Residential mortgage servicing rights			661,819	661,819
Other investments	29,756			29,756
Derivative financial instruments				
Rate lock commitments			25,231	25,231
Forward agency and loan sales		14,366		14,366
Treasury futures	(40,905)			(40,905)
Treasury options	(5,434)			(5,434)
Interest rate swaps	627			627
Total assets at fair value	$(15,956)	$239,885	$1,473,346	$1,697,275

Changes in Level 3 fair value measurements

A determination to classify a financial instrument within Level 3 of the valuation hierarchy is based upon the significance of the unobservable factors to the overall fair value measurement. However, Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources); accordingly, the gains and losses in the table below include changes in fair value due in part to observable factors that are included within the valuation methodology. Also, the Company

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manages the risk associated with the observable components of certain Level 3 financial instruments using securities and derivative positions that are classified within Level 1 or Level 2 of the valuation hierarchy; these Level 1 and Level 2 risk management instruments are not included below, and therefore the gains and losses in the tables do not reflect the effect of the Company s risk management activities related to such Level 3 instruments.

Fair value measurements using significant unobservable inputs

The table below includes a rollforward of the Consolidated Statement of Financial Condition amounts for the six months ended June 30, 2008 (including the change in fair value) for financial instruments classified by the Company within Level 3 of the valuation hierarchy (in thousands).

Six months ended June 30, 2008	Fair value, January 1, 2008	Total realized/ unrealized gains/(losses)	Purchases, issuances and settlements, net	Transfers in and/or out of Level 3	Fair value, June 30, 2008	Changes in unrealized gains and (losses) related to financial instruments held at June 30, 2008[c]
Securities classified as trading:						
Residual interests[a]	$ 13,703	$(12,008)	$	$ 32,087	$ 33,782	$
Securities classified as available for sale[b][c]	33,333	(26,604)	(42,127)	787,912[e]	752,514	(26,604)
Residential mortgage servicing rights [d]	445,962	12,135	203,722		661,819	
Derivative financial Instruments:						
Rate lock commitments	26,129		(898)		25,231	
Totals	$519,127	$(26,477)	$160,697	$819,999	$1,473,346	$(26,604)

(a) Residual interests are valued using internal inputs supplemented by independent third party inputs.

(b) Securities classified as available for sale are valued predominantly using quoted

broker/dealer prices with adjustments to reflect for any assumptions a willing market participant would include in its valuation.

(c) Realized gains (losses) are reported in non-interest income. Unrealized gains (losses) are reported in accumulated other comprehensive income (loss).

(d) Effective January 1, 2008, the Company elected the fair value measurement method for residential MSRs under SFAS 156 (See Note 9 Mortgage Servicing Rights).

(e) Management had anticipated that the AAA-rated non-agency securities would be classified under Level 2 of the valuation hierarchy. However, due to illiquidity in the

markets, the fair value of these securities will be determined using internal models and therefore is classified within Level 3 of the valuation hierarchy.

The Company also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market and had a fair value below cost at the end of the period as summarized below (in thousands).

Assets Measured at Fair Value on a Nonrecurring Basis

	Balance at June 30, 2008	Level 1	Level 2	Level 3
Loans held for investment	$182,926	$	$182,926	$
Repossessed assets	118,582		118,582	
Consumer servicing assets	10,566			10,566
Totals	$312,074	$	$301,508	$10,566

Note 5. Investment Securities

As of June 30, 2008 and December 31, 2007, investment securities were comprised of the following (in thousands):

	June 30, 2008	December 31, 2007
Securities trading	$ 33,782	$ 13,703
Securities available for sale		
AAA-rated non-agencies	$ 752,514	$ 821,245
AAA-rated U.S. government sponsored agencies	225,519	454,030
Non-investment grade residual		33,333
Total securities available for sale	$ 978,033	$ 1,308,608
Mortgage-backed securities held to maturity		
AAA-rated U.S. government sponsored agencies	$	$ 1,255,431
Other investments		
Mutual funds	$ 29,556	$ 26,107
U.S. Treasury bonds	200	706
Total other investments	$ 29,756	$ 26,813

As of January 1, 2008, non-investment grade residuals amounting to $33.3 million that were classified as available for sale securities were reclassified to trading securities in accordance with SFAS 159. No gain or loss was recorded upon reclassification. See Note 4, Fair Value Accounting for further information. At June 30, 2008, the Company had $33.8 million in securities classified as trading. These securities are non-investment grade residual securities from private-label securitizations. The securities are recorded at fair value with any unrealized gains and losses reported in the consolidated statement of earnings. During the quarter ended June 30, 2008, the Company recognized losses related to these trading securities of $4.1 million as a result of the decrease in the fair value of the securities. During the six month period ending June 30, 2008, the Company recognized losses related to these trading securities of $13.6 million as a result of the decrease in the fair value of the securities. The decline in the fair value of these residual securities was principally due to the increase in the actual and expected losses in the second mortgages and home equity lines of credit that underlie this asset. The Company had no losses on trading securities during the quarter or six month period ended June 30, 2007.

At June 30, 2008, the Company had $1.0 billion in securities classified as available for sale which were comprised of AAA-rated U.S. government sponsored agency securities and AAA-rated non-agency securities. Securities available for sale are carried at fair value, with unrealized gains and losses reported as a component of other comprehensive income (loss) to the extent they are temporary in nature. If losses are, at any time, deemed to have arisen from other-than-temporary impairments (OTTI), then they are reported as an expense for that period. There were no losses deemed OTTI for the three or six month periods ended June 30, 2008.

At June 30, 2008 and December 31, 2007, $871.3 million and $570.0 million of the securities classified as available for sale, respectively, were pledged as collateral for security repurchase agreements or FHLB borrowings. Contractual maturities of the securities generally range from 2010 to 2035.

As of March 31, 2008, the Company reclassified $1.2 billion of mortgage-backed securities, which were comprised of AAA-rated U.S. government sponsored agency securities, from held-to-maturity to available-for sale. Upon reclassification, the Company recorded a decrease in the carrying value of such securities of $8.5 million with a corresponding increase to other comprehensive loss. The reclassification was required because the Company s management indicated it no longer had the intent to hold such securities to maturity because of its sale subsequent to

March 31, 2008 of a significant portion of these securities. During the quarter ended June 30, 2008, the Company sold $895.0 million of these securities resulting in a gain of $4.9 million.

The Company has other investments because of interim investment strategies in trust subsidiaries, collateral requirements required in swap and deposit transactions, and Community Reinvestment Act investment requirements.

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The following table summarizes the amortized cost and estimated fair value of agency and non-agency mortgage-backed securities classified as available for sale (in thousands):

	June 30, 2008	December 31, 2007
Amortized cost	$ 1,027,421	$ 1,326,656
Gross unrealized holding gains	102	4,647
Gross unrealized holding losses	(49,490)	(22,695)
Estimated fair value	$ 978,033	$ 1,308,608

At June 30, 2008, $379.8 million non-agency available for sale securities with unrealized losses of $29.0 million had been in a continuous unrealized loss position for greater than twelve months.

The unrealized losses on securities available for sale include $40.6 million on $752.5 million of AAA-rated investments in non-agency collateralized mortgage obligations (CMOs) at June 30, 2008. These CMOs consist of interests in investment vehicles backed by mortgage loans. In all of the CMOs, the Company s investment is senior to a subordinated tranche(s) which have first loss exposure. Management concluded that these unrealized losses are temporary in nature since they are not related to the underlying credit quality of the issuers and the Company has the intent and ability to hold these investments for a time necessary to recover its cost or will ultimately recover its cost at maturity (i.e., these investments have contractual maturities that, absent credit default, should allow the Company to recover its cost). The Company believes that these losses are primarily related to market conditions rather than underlying credit issues associated with the issuers of the obligations. The CMOs were purchased in the fourth quarter of 2006 and first quarter of 2007 and have not experienced any losses to date. The Company does not believe it should have any loss of principal on these investments given its senior position and the protection that the subordinated classes provide.

As of June 30, 2008, the aggregate amount of available for sale securities from each of the following non-agency issuers were greater than 10% of the Company s stockholders equity.

Name of Issuer	Amortized Cost	Fair Value
	(in thousands)	
Countrywide Alternative Loan Trust	$ 83,311	$ 80,300
Countrywide Home Loans	293,408	284,252
Flagstar Home Equity Loan Trust 2006-1	244,397	221,408
Goldman Sachs Mortgage Company	88,743	86,361
JP Morgan Mortgage Trust	83,204	80,193
	$ 793,063	$ 752,514

The following table summarizes the amortized cost and estimated fair value of agency mortgage-backed securities classified as held to maturity (dollars in thousands):

	June 30, 2008	December 31, 2007
Amortized cost	$	$ 1,255,431
Gross unrealized holding gains		33,956
Gross unrealized holding losses		(304)

Estimated fair value	$	$ 1,289,083

Note 6. Loans Available for Sale

The following table summarizes loans available for sale (dollars in thousands):

	June 30, 2008	December 31, 2007
Mortgage loans	$ 2,706,372	$ 3,083,779
Consumer loans		170,891
Second mortgage loans		256,640
Total	$ 2,706,372	$ 3,511,310

During the quarter ended June 30, 2008, certain mortgage loans and all consumer loans and second mortgage loans classified as available for sale were reclassified as held for investment because management no longer has the intent to sell such loans. The change in managements intent with respect to these loans was caused by the continued disruption of the secondary market. The loans reclassified to held for investment were transferred at fair value. Such loans were written down to a fair value of $648.7 million which resulted in a loss of $22.5 million that was included in net gain on loan sales. Of the $22.5 million loss, approximately $16.0 million was attributed to estimated credit losses inherent in the loans transferred. During the quarter ended March 31, 2008, management reclassified approximately $592.9 million of mortgage loans from loans available for sale to loans held for investment. Such loans were reclassified at fair value and resulted in a $0.2 million loss on loan sales.

Loans available for sale are carried at the lower of aggregate cost or estimated fair value. These loans had an aggregate fair value that exceeded their recorded amount for each period presented. The Company generally estimates the fair value of mortgage loans based on quoted market prices for securities backed by similar types of loans. Given the lack of liquidity in the secondary mortgage market at June 30, 2008 and December 31, 2007, significant management judgment was necessary to estimate the fair value of loans available for sale. Where quoted market prices were available, such market prices were utilized as estimates for fair values. Otherwise, the fair values of loans were estimated by discounting estimated cash flows using management s best estimate of market interest rates and loss assumptions for similar collateral.

Note 7. Loans Held for Investment

Loans held for investment are summarized as follows (dollars in thousands):

	June 30, 2008	December 31, 2007
Mortgage loans	$ 6,042,770	$ 5,823,952
Second mortgage loans	294,783	56,516
Commercial real estate loans	1,706,191	1,542,104
Construction loans	71,345	90,401
Warehouse lending	423,356	316,719
Consumer loans	529,034	281,746
Commercial loans	23,783	22,959
Total	9,091,262	8,134,397
Less allowance for loan losses	(154,000)	(104,000)
Total	$ 8,937,262	$ 8,030,397

Activity in the allowance for loan losses is summarized as follows (dollars in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Balance, beginning of period	$121,400	$48,500	$104,000	$ 45,779
Provision charged to operations	43,833	11,452	78,095	19,745
Charge-offs	(11,987)	(7,552)	(29,179)	(13,851)
Recoveries	754	1,000	1,084	1,727
Balance, end of period	$154,000	$53,400	$154,000	$ 53,400

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Loans on which interest accruals have been discontinued totaled approximately $364.3 million and $99.3 million at June 30, 2008 and 2007, respectively. Interest on these loans is recognized as income when collected. Interest that would have been accrued on such loans totaled approximately $7.2 million and $1.6 million during the six months ended June 30, 2008 and 2007, respectively. There were no loans greater than 90 days past due still accruing interest on the OTS method at June 30, 2008 and 2007.

A loan is impaired when it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. Impaired loans were as follows (dollars in thousands):

	June 30, 2008	December 31, 2007
Impaired loans with no allowance for loan losses allocated	$ 46,347	$ 22,307
Impaired loans with allowance for loan losses allocated	190,094	112,044
Total impaired loans	$236,441	$134,351
Amount of the allowance allocated to impaired loans	$ 47,883	$ 34,937
Average investment in impaired loans	$186,269	$ 70,582
Cash-basis interest income recognized during impairment	$ 4,282	$ 2,324

Those impaired loans with no allowance for loan losses allocated represent loans for which the fair value of the related collateral less estimated selling costs exceeded the recorded investments in such loans. At June 30, 2008, approximately 97.0% of the total impaired loans were evaluated based on the fair value of related collateral.

Note 8. Private-label Securitization Activity

At June 30, 2008, key assumptions used in determining the value of residual interests resulting from the Company s private-label securitizations were as follows:

	Prepayment Speed	Projected Credit Losses	Annual Discount Rate	Weighted - Average Life (in years)
2005 HELOC Securitization	20%	3.84%	20%	2.7
2006 HELOC Securitization	19%	9.12%	20%	3.5
2006 Second Mortgage Securitization	16%	3.46%	20%	4.4
2007 Second Mortgage Securitization	16%	4.31%	20%	4.8

Effective as of the beginning of the second quarter of 2008 and in accordance with the terms of the 2005 HELOC securitization, credit losses in the securitization exceeded los