

FLAGSTAR BANCORP INC

Form 10-Q

November 10, 2008

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

(Mark One)

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

**For the quarterly period ended September 30, 2008**

**OR**

☐ **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 ☒ No ☐.

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting  
company ☐

(Do not check if smaller  
reporting company)

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

As of November 6, 2008, 83,626,726 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, assumes, expects, anticipates, plans, trend, objective, continue, remain, pattern or similar expressions or future or similar verbs such 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 of 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.

**FLAGSTAR BANCORP, INC.**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 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 September 30, 2008 (unaudited) and December 31, 2007.

Unaudited Consolidated Statements of Operations For the three and nine months ended September 30, 2008 and 2007.

Consolidated Statements of Stockholders Equity and Comprehensive Loss For the nine months ended September 30, 2008 (unaudited) and for the year ended December 31, 2007.

Unaudited Consolidated Statements of Cash Flows For the nine months ended September 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)

	<b>At September 30, 2008 (Unaudited)</b>	<b>At December 31, 2007</b>
<b>Assets</b>		
Cash and cash items	\$ 155,889	\$ 129,992
Interest-bearing deposits	192,046	210,177
Cash and cash equivalents	347,935	340,169
Securities classified as trading	23,074	13,703
Securities classified as available for sale	1,041,446	1,308,608
Mortgage-backed securities held to maturity (fair value \$1.3 billion at December 31, 2007)		1,255,431
Other investments	31,826	26,813
Loans available for sale	1,961,352	3,511,310
Loans held for investment	9,134,884	8,134,397
Less: allowance for loan losses	(224,000)	(104,000)
Loans held for investment, net	8,910,884	8,030,397
Total interest-earning assets	12,160,628	14,356,439
Accrued interest receivable	53,308	57,888
Reposessed assets, net	119,205	95,074
Federal Home Loan Bank stock	373,443	348,944
Premises and equipment, net	246,340	237,652
Mortgage servicing rights at fair value	722,159	
Mortgage servicing rights, net	9,992	413,986
Other assets	318,405	151,120
Total assets	\$ 14,159,369	\$ 15,791,095
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Deposits	\$ 7,420,804	\$ 8,236,744
Federal Home Loan Bank advances	5,438,000	6,301,000
Security repurchase agreements	108,000	108,000
Long term debt	248,660	248,685
Total interest-bearing liabilities	13,215,464	14,894,429
Accrued interest payable	27,237	47,070
Secondary market reserve	28,600	27,600
Other liabilities	211,597	129,018
Total liabilities	13,482,898	15,098,117
Commitments and Contingencies		

**Stockholders' Equity**

Preferred stock \$0.01 par value, 25,000,000 shares authorized; no shares outstanding

Common stock \$0.01 par value, 150,000,000 shares authorized; 83,626,726 and 63,656,979 shares issued, and 83,626,726 and 60,270,624 shares outstanding at September 30, 2008 and

December 31, 2007, respectively	836	637
Additional paid in capital	118,664	64,350
Accumulated other comprehensive loss	(95,668)	(11,495)
Retained earnings	652,639	681,165
Treasury stock, at cost, no shares at September 30, 2008, and 3,386,355 shares at December 31, 2007		(41,679)

Total stockholders' equity	676,471	692,978
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Total liabilities and stockholders' equity	\$ 14,159,369	\$ 15,791,095
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**The accompanying notes are an integral part of these consolidated financial statements.**

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
	(Unaudited)			
<b>Interest Income</b>				
Loans	\$172,163	\$201,464	\$526,039	\$578,673
Mortgage-backed securities held to maturity		15,485	15,576	43,869
Securities available for sale	14,563	15,212	51,325	42,334
Interest-bearing deposits	1,416	3,647	5,561	9,823
Other	395	1,343	1,453	5,486
Total interest income	188,537	237,151	599,954	680,185
<b>Interest Expense</b>				
Deposits	60,940	91,117	215,807	262,181
FHLB advances	62,348	70,534	190,168	203,268
Federal reserve borrowings	419		484	
Security repurchase agreements	1,179	17,982	5,541	48,416
Other	3,810	3,582	11,916	10,495
Total interest expense	128,696	183,215	423,916	524,360
Net interest income	59,841	53,936	176,038	155,825
Provision for loan losses	89,612	30,195	167,708	49,941
Net interest income (loss) after provision for loan losses	(29,771)	23,741	8,330	105,884
<b>Non-Interest Income</b>				
Loan fees and charges	777	(218)	2,278	1,257
Deposit fees and charges	7,183	5,808	20,029	16,496
Loan administration	25,655	4,333	45,980	10,097
Net gain (loss) on loan sales	22,152	(17,457)	129,403	35,841
Net gain on sales of mortgage servicing rights	896	456	348	6,181
Net gain (loss) on sales of securities available for sale	149	(2,944)	5,019	(2,215)
(Loss) gain on trading securities	(12,899)	1,914	(26,485)	1,914
Other fees and charges	9,475	9,376	29,768	29,039
Total non-interest income	53,388	1,268	206,340	98,610
<b>Non-Interest Expense</b>				
Compensation and benefits	51,461	40,037	157,538	118,680
Occupancy and equipment	19,462	17,599	59,721	51,380
Asset resolution	18,019	1,952	29,799	6,912



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General and administrative	30,222	13,672	55,010	39,920
Total non-interest expense	119,164	73,260	302,068	216,892
Loss before federal income taxes	(95,547)	(48,251)	(87,398)	(12,398)
Benefit for federal income taxes	(33,456)	(16,196)	(30,454)	(3,233)
<b>Net Loss</b>	<b>\$ (62,091)</b>	<b>\$ (32,055)</b>	<b>\$ (56,944)</b>	<b>\$ (9,165)</b>
Loss per share				
Basic	\$ (0.79)	\$ (0.53)	\$ (0.83)	\$ (0.15)
Diluted	\$ (0.79)	\$ (0.53)	\$ (0.83)	\$ (0.15)

**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 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
<b>Balance at January 1, 2007</b>	\$	\$ 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)
<b>Balance at December 31, 2007 (Unaudited)</b>		637	64,350	(11,495)	681,165	(41,679)	692,978
Net loss					(56,944)		(56,944)
Reclassification of gain on				(236)			(236)

dedesignation of swaps used in cash flow hedges									
Change in net unrealized loss on securities available for sale					(83,937)				(83,937)
Total comprehensive loss									(141,117)
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		199	54,162						54,361
Issuance of treasury stock							41,092		41,092
Conversion of preferred stock	(1)		(45,796)						(45,797)
Restricted stock issued			(587)				587		
Stock options exercised			77						77
Stock-based compensation			867						867
Tax effect from stock-based compensation			(205)						(205)
<b>Balance at September 30, 2008</b>	\$	\$ 836	\$ 118,664	\$	(95,668)	\$ 652,639	\$	\$	676,471

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)

	<b>For the Nine Months Ended September</b>	
	<b>2008</b>	<b>2007</b>
	30, (Unaudited)	
<b>Operating Activities</b>		
Net loss	\$ (56,944)	\$ (9,165)
Adjustments to net loss to net cash used in operating activities		
Provision for loan losses	167,708	49,941
Depreciation	17,015	19,024
Amortization of MSRs	1,949	52,668
Decrease in valuation allowance in mortgage servicing rights	(82)	(358)
Loss on fair value of residential mortgage servicing rights, net of hedging gains (losses)	58,839	
Stock-based compensation expense	867	1,119
Loss on interest rate swaps	149	
Net gain on the sale of assets	(429)	(3,041)
Net gain on loan sales	(129,403)	(35,841)
Net gain on sales of mortgage servicing rights	(348)	(6,181)
Net (gain) loss on securities classified as available for sale	(5,019)	2,215
Unrealized (gain) loss on trading securities	26,485	(1,914)
Proceeds from sales and securitization of loans available for sale	18,745,006	16,031,878
Origination and repurchase of mortgage loans available for sale, net of principal repayments	(21,068,787)	(19,018,391)
Decrease (increase) in accrued interest receivable	4,580	(11,062)
(Increase) decrease in other assets	(88,256)	387
Decrease in accrued interest payable	(19,833)	(119)
Net tax effect of stock grants issued	205	25
Decrease in federal income taxes payable	(98,996)	(21,229)
Decrease in payable for securities purchased		(249,694)
Increase in other liabilities	47,591	8,318
Net cash used in operating activities	(2,397,703)	(3,191,420)
<b>Investing Activities</b>		
Net change in other investments	(5,013)	(745)
Repayment of mortgage-backed securities held to maturity	90,846	249,475
Proceeds from sale of investment securities available for sale	913,798	254,937
Repayment (purchase) of investment securities available for sale	138,988	(132,755)
Proceeds from sales of portfolio loans	1,312,084	693,283
Origination of portfolio loans, net of principal repayments	1,474,806	708,063
Purchase of Federal Home Loan Bank stock	(24,499)	(53,524)
Investment in unconsolidated subsidiary		1,238
Proceeds from the disposition of repossessed assets	78,447	70,318
Acquisitions of premises and equipment, net of proceeds	(24,240)	(25,891)
Proceeds from the sale of mortgage servicing rights		33,915

Net cash provided by investing activities	3,955,217	1,798,314
<b>Financing Activities</b>		
Net (decrease) increase in deposit accounts	(815,940)	862,068
Net decrease in security repurchase agreements		(522,138)
Net (decrease) increase in Federal Home Loan Bank advances	(863,000)	985,000
Payment on other long term debt	(25)	
Issuance of junior subordinated debt		40,000
Net receipt of payments of loans serviced for others	21,005	17,069
Net receipt of escrow payments	12,885	19,931
Proceeds from the exercise of stock options	77	(241)
Net tax effect of stock grants issued	(205)	(25)
Issuance of preferred stock	45,797	
Issuance of common stock	8,566	
Issuance of treasury stock	41,092	26

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	<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
	(Unaudited)	
Dividends paid to stockholders		(18,361)
Purchase of treasury stock		(41,705)
Net cash (used in) provided by financing activities	(1,549,748)	1,341,599
Net increase (decrease) in cash and cash equivalents	7,766	(51,507)
Beginning cash and cash equivalents	340,169	277,236
Ending cash and cash equivalents	\$ 347,935	\$ 225,729
<b>Supplemental disclosure of cash flow information:</b>		
Loans held for investment transferred to repossessed assets	\$ 149,855	\$ 88,576
Total interest payments made on deposits and other borrowings	\$ 443,748	\$ 524,479
Federal income taxes paid	\$ 5,808	\$
Reclassification of mortgage loans originated for portfolio to mortgage loans available for sale	\$ 280,635	\$ 693,283
Reclassification of mortgage loans originated available for sale then transferred to portfolio loans	\$ 1,583,069	\$ 210,639
Mortgage servicing rights resulting from sale or securitization of loans	\$ 292,004	\$ 247,570
Reclassification of mortgage backed securities held to maturity to securities available for sale	\$ 1,163,681	\$
Retention of residual interests in securitization transactions	\$	\$ 20,487
Recharacterization of mortgage loans available for sale to mortgage-backed securities available for sale	\$	\$ 406,094
Recharacterization of loans held for investment to mortgage-backed securities held to maturity	\$	\$ 345,794
Conversion of mandatory convertible non-cumulative perpetual preferred stock	\$ 45,797	\$

**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 \$14.2 billion in assets at September 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, although the Company has recently suspended originating substantially all loans other than those that are eligible for sale through Fannie Mae or Freddie Mac or insured through the Federal Housing Administration ( FHA ).

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 consolidated 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 over the longer term.

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 consolidated 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 nine month periods ended September 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](http://www.flagstar.com), and on the website of the SEC, at [www.sec.gov](http://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



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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 operations. 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 U.S. GAAP. 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 was 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 \$6.7 million during the three month period ended September 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 U.S. GAAP (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 consolidated 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 consolidated 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 nine months ended September 30, 2008 was \$10.7 million and \$23.9 million, respectively, before taxes, which is included within the total loss on trading securities reported in the Company's consolidated statement of operations.

Effective January 1, 2008, the Company elected the fair value measurement method for residential mortgage servicing rights (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 operations.

### **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 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 September 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.

*Reposessed assets.* Loans on which the underlying collateral has been reposessed are adjusted to fair value upon transfer to reposessed assets. Subsequently, reposessed 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 reposessed 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 MSR's under SFAS 156. Upon this election, residential MSR's 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 MSR's. 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 MSR's 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 MSR's 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 September 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	\$	\$	\$ 23,074	\$ 23,074
Securities classified as available for sale		407,758	633,688	1,041,446
Residential mortgage servicing rights			722,159	722,159
Other investments	31,826			31,826
Derivative financial instruments				
Rate lock commitments			10,216	10,216
Forward agency and loan sales		21,180		21,180
Treasury futures	(19,802)			(19,802)
Treasury options	(24,316)			(24,316)
Interest rate swaps	(149)			(149)
<b>Total assets at fair value</b>	<b>\$(12,441)</b>	<b>\$428,938</b>	<b>\$1,389,137</b>	<b>\$1,805,634</b>

**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 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



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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 nine months ended September 30, 2008 (including the change in fair value) for financial instruments classified by the Company within Level 3 of the valuation hierarchy (in thousands).

			Purchases, issuances	Transfers in		Changes in unrealized gains and (losses) related to financial instruments
Nine months ended September 30, 2008	Fair value, January 1, 2008	Total realized/ unrealized gains/(losses)	and settlements, net	and/or out of Level 3	Fair value, September 30, 2008	held at September 30, 2008 <sup>(c)</sup>
Securities classified as trading:						
Residual interests <sup>(a)</sup>	\$ 13,703	\$ (22,716)	\$	\$ 32,087	\$ 23,074	\$
Securities classified as available for sale <sup>(b) (c) (e)</sup>	33,333	(127,986)	(59,571)	787,912	633,688	(127,986)
Residential mortgage servicing rights <sup>(d)</sup>	445,962	(15,691)	291,888		722,159	
Derivative financial Instruments:						
Rate lock commitments	26,129		(15,913)		10,216	
<b>Totals</b>	<b>\$519,127</b>	<b>\$(166,393)</b>	<b>\$216,404</b>	<b>\$819,999</b>	<b>\$1,389,137</b>	<b>\$(127,986)</b>

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

(b) U.S. government agency 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.

Non-agency securities classified as available for sale are valued using internal valuation models and pricing information from third parties.

- (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 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 and pricing information from third parties.

The Company also has assets that under certain conditions are subject to measurement at fair value on a nonrecurring 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**

	<b>Balance at September 30, 2008</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Loans held for investment	\$257,995	\$	\$257,995	\$
Reposessed assets	119,205		119,205	
Consumer servicing assets	9,992			9,992
Totals	\$387,192	\$	\$377,200	\$9,992

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

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
<b>Securities trading</b>	\$ 23,074	\$ 13,703
<b>Securities available for sale</b>		
Non-agencies	\$ 633,688	\$ 821,245
U.S. government sponsored agencies	407,758	454,030
Non-investment grade residual		33,333
Total securities available for sale	\$ 1,041,446	\$ 1,308,608
<b>Mortgage-backed securities held to maturity</b>		
AAA-rated U.S. government sponsored agencies	\$	\$ 1,255,431
<b>Other investments</b>		
Mutual funds	\$ 31,826	\$ 26,107
U.S. Treasury bonds		706
Total other investments	\$ 31,826	\$ 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 September 30, 2008, the Company had \$23.1 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 operations. During the quarter ended September 30, 2008, the Company recognized losses related to these trading securities of \$12.9 million as a result of the decrease in the fair value of the securities. During the nine month period ending September 30, 2008, the Company recognized losses related to these trading securities of \$26.5 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 these assets. Additionally, during the third quarter of 2008, the values of certain of these assets were affected by the tightening of the spread between the three month LIBOR rate and the prime rate. The Company had gains on trading securities amounting to \$1.9 million during the quarter and nine month period ended September 30, 2007.

At September 30, 2008, the Company had \$1.0 billion in securities classified as available for sale which were comprised of U.S. government sponsored agency securities and non-agency securities. Securities available for sale are carried at fair value, with unrealized gains and losses reported as a component of other comprehensive 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.

At September 30, 2008 and December 31, 2007, \$895.7 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 2020 to 2038.

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 September 30, 2008, the Company sold \$13.8 million of these securities resulting in a gain of \$0.1 million. For the nine months ended September 30, 2008, the Company sold \$908.8 million of these securities for a gain of \$5.0 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):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Amortized cost	\$ 1,188,627	\$ 1,326,656
Gross unrealized holding gains	933	4,647
Gross unrealized holding losses	(148,114)	(22,695)
Estimated fair value	\$ 1,041,446	\$ 1,308,608

The unrealized losses on securities available for sale include \$141.9 million on investments in non-agency collateralized mortgage obligations ( CMOs ) at September 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. At September 30, 2008, \$336.1 million of non-agency available for sale securities with unrealized losses of \$61.7 million had been in a continuous unrealized loss position for greater than twelve months. 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.

As of September 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.

<b>Name of Issuer</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
	(in thousands)	
Countrywide Alternative Loan Trust	\$ 119,869	\$ 62,931
Countrywide Home Loans	250,773	213,267
Flagstar Home Equity Loan Trust 2006-1	236,500	207,880
Goldman Sachs Mortgage Company	87,030	77,192
JP Morgan Mortgage Trust	81,464	72,418
	\$ 775,636	\$ 633,688

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

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
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):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Mortgage loans	\$ 1,961,341	\$ 3,083,779
Consumer loans		170,891
Second mortgage loans	11	256,640
Total	\$ 1,961,352	\$ 3,511,310

During the nine months ended September 30, 2008, management reclassified approximately \$1.6 billion of mortgage loans, consumer loans and second mortgage loans from loans available for sale to loans held for investment. Such loans were

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reclassified at fair value and resulted in losses on loan sales of \$34.7 million. The loans were reclassified because management no longer has the intent to sell such loans. The change in management's intent was caused by the continued disruption of the secondary market.

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 September 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, prepayment speeds and loss assumptions for similar collateral.

**Note 7. Loans Held for Investment**

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

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Mortgage loans	\$ 6,134,305	\$ 5,823,952
Second mortgage loans	291,523	56,516
Commercial real estate loans	1,737,152	1,542,104
Construction loans	65,814	90,401
Warehouse lending	344,731	316,719
Consumer loans	536,759	281,746
Commercial loans	24,600	22,959
Total	9,134,884	8,134,397
Less allowance for loan losses	(224,000)	(104,000)
Total	\$ 8,910,884	\$ 8,030,397

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

	<b>For the Three Months Ended September 30, 2008</b>		<b>For the Nine Months Ended September 30, 2008</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Balance, beginning of period	\$ 154,000	\$ 53,400	\$ 104,000	\$ 45,779
Provision charged to operations	89,612	30,196	167,708	49,941
Charge-offs	(20,066)	(6,895)	(49,246)	(20,746)
Recoveries	454	1,099	1,538	2,826
Balance, end of period	\$ 224,000	\$ 77,800	\$ 224,000	\$ 77,800

Loans on which interest accruals have been discontinued totaled approximately \$485.8 million and \$166.1 million at September 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 \$10.8 million and \$2.3 million during the nine months ended September 30, 2008 and 2007, respectively.

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):



	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Impaired loans with no allowance for loan losses allocated	\$ 51,140	\$ 22,307
Impaired loans with allowance for loan losses allocated	266,536	112,044
Total impaired loans	\$317,676	\$134,351
Amount of the allowance allocated to impaired loans	\$ 77,233	\$ 34,937
Average investment in impaired loans	\$186,269	\$ 70,582
Cash-basis interest income recognized during impairment	\$ 7,248	\$ 2,324

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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 September 30, 2008, approximately 97.3% of the total impaired loans were evaluated based on the fair value of related collateral.

**Note 8. Private-label Securitization Activity**

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

	<b>Prepayment Speed</b>	<b>Projected Credit Losses</b>	<b>Annual Discount Rate</b>	<b>Weighted Average Life (in years)</b>
2005 HELOC Securitization	16%	4.10%	20%	3.2
2006 HELOC Securitization	11%	12.22%	20%	5.7
2006 Second Mortgage Securitization	9%	3.53%	20%	6.2
2007 Second Mortgage Securitization	11%	5.52%	20%	6.4

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 losses as originally modeled. As such, the monoline insurer that protects the bondholders determined that the status of the securitization should be changed to rapid amortization. During the rapid amortization period, the Company will no longer be reimbursed for draws on the home equity lines of credit until after the bondholders are paid off. Therefore, this status has the effect of extending the time period for which the Company's advances are outstanding and may result in the Company not receiving reimbursement for all of the funds advanced. The 2006 HELOC securitization became subject to rapid amortization during the fourth quarter of 2007. Therefore, both of the Company's HELOC securitizations are in rapid amortization.

Certain cash flows received from securitization trusts outstanding were as follows (in thousands):

	<b>For the Three Months Ended September 30, 2008</b>		<b>For the Nine Months Ended September 30, 2008</b>	
		<b>2007</b>		<b>2007</b>
Proceeds from new securitizations	\$	\$	\$	\$719,097
Proceeds from collections reinvested in securitizations		93,869	6,960	184,817
Servicing fees received	1,604	1,928	5,037	5,050
Loan repurchases for representations and warranties			(1,501)	(642)

**Credit Risk on Securitization**

With respect to the issuance of private-label securitizations, the Company retains certain limited credit exposure in that it retains non-investment grade residual securities in addition to customary representations and warranties. The Company does not have credit exposure associated with non-performing loans in securitizations beyond its residual interests and the amount of draws on HELOCs that it funds and which are not reimbursed by the respective trust. The value of the Company's residual interests includes the Company's credit loss assumptions as to the underlying collateral pool. To the extent that actual credit losses exceed these assumptions, the value of the Company's residual interests will be diminished.

The following table summarizes the loan balance associated with the Company's servicing portfolio and the balance of related retained assets with credit exposure, which includes residual interests that are included as trading securities and unreimbursed HELOC draws that are included in loans held for investment at September 30, 2008 (in thousands):

	<b>Total Loans Serviced</b>	<b>Balance of Retained Assets with Credit Exposure</b>
Private-label securitizations	\$ 1,242,740	\$ 63,245
Government sponsored agencies	50,587,417	
Other investors	550	
Total	\$ 51,830,707	\$ 63,245

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Mortgage loans that have been securitized in private-label securitizations at September 30, 2008 and 2007 that are sixty days or more past due and the credit losses incurred in the securitization trusts are presented below (in thousands):

	<b>Total Principal Amount of Loans Outstanding September 30,</b>		<b>Principal Amount Of Loans 60 Days Or More Past Due September 30,</b>		<b>Credit Losses (Net of Recoveries) For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Securitized mortgages	\$ 1,242,740	\$ 1,467,933	\$ 42,050	\$ 12,869	\$ 42,966	\$ 14,781

**Note 9. Mortgage Servicing Rights**

The Company has obligations to service residential first mortgage loans and consumer loans (HELOC and second mortgage loans resulting from private-label securitization transactions). A description of these classes of servicing assets follows.

**Residential Mortgage Servicing Rights.** Servicing of residential first mortgage loans is a significant business activity of the Company. The Company recognizes MSR assets on residential first mortgage loans when it retains the obligation to service these loans upon sale and the servicing fee is more than adequate compensation. MSRs are subject to changes in value from, among other things, changes in interest rates, prepayments of the underlying loans and changes in credit quality of the underlying portfolio. Historically, the Company has treated this risk as a counterbalance to the increased production and gain on loan sale margins that tend to occur in an environment with increased prepayments. In the quarter ended March 31, 2008, the Company began to specifically hedge the risk by hedging the fair value of MSRs with derivative instruments that are intended to change in value inversely to part or all of the changes in the value of MSRs.

Changes in the carrying value of residential MSRs, accounted for at fair value, for the nine month period ended September 30, 2008 were as follows:

	<b>For the Nine Month Period Ended September 30, 2008 (In Thousands)</b>
Balance at beginning of period	\$ 402,243
Cumulative effect of change in accounting	43,719
Additions from loans sold with servicing retained	291,888
Changes in fair value due to:	
Payoffs <sup>(a)</sup>	(42,765)
All other changes in valuation inputs or assumptions <sup>(b)</sup>	27,074
Fair value of MSRs at end of period	\$ 722,159
Unpaid principal balance of residential mortgage loans serviced for others	\$ 50,587,967

(a) Represents decrease in MSR value

associated with  
loans that paid  
off during the  
period.

- (b) Represents  
estimated MSR  
value change  
resulting  
primarily from  
market-driven  
changes in  
interest rates.

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Prior to January 1, 2008, all residential MSRs were accounted for at the lower of their initial carrying value, net of accumulated amortization, or fair value. Residential MSRs were periodically evaluated for impairment and a valuation allowance established through a charge to operations when the carrying value exceeded the fair value and was believed to be temporary. Other-than-temporary impairments were recognized if the recoverability of the carrying value was determined to be remote. There were no other-than-temporary impairments recognized during 2007. Changes in the carrying value of the residential MSRs, accounted for using the amortization method, and the associated valuation allowance for the nine month period ended September 30, 2007 follow:

	<b>For the Nine Month Period Ended September 30, 2007 (In Thousands)</b>
Balance at beginning of period	\$ 166,705
Additions from loans sold with servicing retained	239,482
Amortization	(50,361)
Sales	(27,733)
Carrying value before valuation allowance at end of period	328,093
Valuation allowance	
Balance at beginning of period	(358)
Impairment recoveries	358
Balance at end of period	
Net carrying value of amortization method MSRs at end of period	\$ 328,093
Unpaid principal balance of residential mortgage loans serviced for others	\$ 25,197,119
Fair value of residential MSRs:	
Beginning of period	\$ 190,875
End of period	\$ 373,309

The fair value of residential MSRs is estimated using a valuation model that calculates the present value of estimated future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors, which are determined based on current market conditions. The Company periodically obtains third-party valuations of its residential MSRs to assess the reasonableness of the fair value calculated by the valuation model.

The key economic assumptions used in determining the fair value of MSRs capitalized during the nine month periods ended September 30, 2008 and 2007 periods were as follows:

	<b>2008</b>	<b>2007</b>
Weighted-average life (in years)	6.6	6.2
Weighted-average constant prepayment rate (CPR)	12.9%	17.7%
Weighted-average discount rate	9.3%	9.8%

The key economic assumptions used in determining the fair value of MSRs at period end were as follows:

	September 30,	
	2008	2007
Weighted-average life (in years)	6.7	5.6
Weighted-average CPR	13.2%	16.5%
Weighted-average discount rate	10.7%	9.8%

**Consumer Servicing Assets.** Consumer servicing assets represent servicing rights related to HELOC and second mortgage loans that were created in the Company's private-label securitizations. These servicing assets are initially measured at fair value and subsequently accounted for using the amortization method. Under this method, the assets are amortized in proportion to and over the period of estimated servicing income and are evaluated for impairment on a periodic basis. When the carrying value exceeds the fair value and is believed to be temporary, a valuation allowance is established by a charge to loan administration income in the consolidated statement of operations. Other-than-temporary impairment is recognized when the recoverability of the carrying value is determined to be remote. When this situation occurs, the unrecoverable portion of the valuation allowance is applied as a direct write-down to the carrying value of the consumer servicing asset. Unlike a

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valuation allowance, a direct write-down permanently reduces the carrying value of the consumer servicing asset and the valuation allowance, precluding recognition of subsequent recoveries. There were no other-than-temporary impairments on consumer servicing assets recognized during the three or nine month periods ended September 30, 2008 and 2007.

The fair value of consumer servicing assets is estimated by using an internal valuation model. This method is based on calculating the present value of estimated future net servicing cash flows, taking into consideration discount rates, actual and expected loan prepayment rates, servicing costs and other economic factors. The internal valuation model is validated periodically through a third-party valuation.

Changes in the carrying value of the consumer servicing assets and the associated valuation allowance follow:

	<b>For the Nine Month Period Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
	(In Thousands)	
Consumer servicing assets		
Balance at beginning of period	\$ 11,914	\$ 6,846
Additions:		
From loans securitized with servicing retained	116	8,078
Subtractions:		
Amortization	(1,949)	(2,462)
Carrying value before valuation allowance at end of period	10,081	12,462
Valuation allowance		
Balance at beginning of period	(144)	(150)
Impairment recoveries (charges)	55	(37)
Balance at end of period	(89)	(187)
Net carrying value of servicing assets at end of period	\$ 9,992	\$ 12,275
Unpaid principal balance of consumer loans serviced for others	\$ 1,242,740	\$ 1,467,933
Fair value of servicing assets:		
Beginning of period	\$ 11,861	\$ 6,757
End of period	\$ 10,167	\$ 12,291

The key economic assumptions used to estimate the fair value of these servicing assets at September 30, 2008 and 2007 were as follows:

	<b>September 30</b>	
	<b>2008</b>	<b>2007</b>
Weighted-average life (in years)	3.9	2.7
Weighted-average discount rate	13.7%	12.7%

**Contractual Servicing Fees.** Contractual servicing fees, including late fees and ancillary income, for each type of loan serviced are presented below. Contractual servicing fees are included within loan administration income on the consolidated statements of operations (in thousands).



	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Residential real estate	\$ 39,423	\$ 20,642	\$ 101,691	\$ 54,499
Consumer	2,299	2,676	4,963	5,256
Total	\$ 41,722	\$ 23,318	\$ 106,654	\$ 59,755

**Table of Contents****Note 10. Accumulated Other Comprehensive Loss**

The following table sets forth the ending balance in accumulated other comprehensive loss for each component (in thousands):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Net unrealized gain on derivatives used in cash flow hedges	\$	\$ 236
Net unrealized loss on securities available for sale	(95,668)	(11,731)
Ending balance	\$ (95,668)	\$ (11,495)

The following table sets forth the changes to other comprehensive loss and the related tax effect for each component (in thousands):

	<b>For the Nine Months Ended September 30, 2008</b>	<b>For the Year Ended December 31, 2007</b>
Gain (reclassified to earnings) on interest rate swap extinguishment	\$	\$ (155)
Related tax benefit		54
Unrealized loss on derivatives used in cash flow hedging relationships		(11,377)
Related tax (expense) benefit		3,981
Reclassification adjustment for gains (losses) included in earnings relating to cash flow hedging relationships		5,290
Related tax expense		(1,851)
Gain (reclassified to earnings) on interest rate swap derecognition	(363)	
Related tax benefit	127	
Unrealized loss on securities available for sale	(129,134)	(19,414)
Related tax benefit	45,197	6,795
Change	\$ (84,173)	\$ (16,677)

**Note 11. Derivative Financial Instruments**

The Company follows the provisions of SFAS 133, as amended, for its derivative instruments and hedging activities, which require it to recognize all derivative instruments on the consolidated statements of financial condition at fair value. The following derivative financial instruments were identified and recorded at fair value as of September 30, 2008 and December 31, 2007:

- Fannie Mae, Freddie Mac and other forward loan sales contracts;
- Rate lock commitments;
- Interest rate swap agreements; and
- Treasury futures and options.

The Company hedges the risk of overall changes in fair value of loans held for sale and rate lock commitments generally by selling forward contracts on securities of Fannie Mae, Freddie Mac and Ginnie Mae. Under SFAS 133, certain of these positions may qualify as a fair value hedge of a portion of the funded loan portfolio and result in adjustments to the carrying value of designated loans through gain on sale based on value changes attributable to the hedged risk. The forward contracts used to economically hedge the loan commitments are accounted for as

non-designated hedges and naturally offset rate lock commitment mark-to-market gains and losses recognized as a component of gain on loan sale. The Bank recognized pre-tax losses of \$8.2 million and \$8.5 million for the three months ended September 30, 2008 and 2007, respectively, on its hedging activity relating to loan commitments and loans held for sale. The Bank recognized pre-tax gains (losses) of \$18.8 million and \$(1.0) million for the nine months ended September 30, 2008 and 2007, respectively, on its hedging activity relating to loan commitments and loans held for sale.

The Company uses interest rate swap agreements to reduce its exposure to interest rate risk inherent in a portion of the current borrowings and anticipated deposits. A swap agreement is a contract between two parties to exchange cash flows based on specified underlying notional amounts and indices. Under SFAS 133, the swap agreements used to hedge the Company's anticipated borrowings and advances qualify as cash flow hedges. Derivative gains and losses reclassified from accumulated other comprehensive loss to current period operations are included in the line item in which the hedged cash flows are recorded. At December 31, 2007, accumulated other comprehensive loss included a deferred after-tax net gain of

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\$0.2 million related to derivatives used to hedge funding cash flows. On January 1, 2008, the Company derecognized all cash flow hedges. As such, the after-tax net gain of \$0.2 million in accumulated other comprehensive loss at December 31, 2007 was recognized through operations during 2008.

The Company recognizes ineffective changes in hedge values resulting from designated SFAS 133 hedges discussed above in the same statement of operations captions as effective changes when such material ineffectiveness occurs. There were no components of derivative instruments that were excluded from the assessment of hedge effectiveness. For 2007, the Company did not recognize any significant gains or losses due to ineffectiveness of its cash flow hedges. The Company had no designated cash flow hedges during 2008.

Beginning in the first quarter of 2008, the Company began to hedge its residential MSR asset through the use of U.S. Treasury futures and options in order to mitigate the effect of changes in and volatility of the interest rate environment. Changes in the values of these derivative instruments are included in loan administration income in the non-interest income portion of the consolidated statement of operations. Because the residential MSRs are accounted for on the fair value method, gains or losses in hedging activities are expected to be offset by increases or decreases in the fair value of the residential MSR asset, although such changes may not be perfectly correlated.

The Company had the following derivative financial instruments (dollars in thousands):

	<b>September 30, 2008</b>		
	<b>Notional Amounts</b>	<b>Fair Value</b>	<b>Expiration Dates</b>
Mortgage banking derivatives:			
Rate lock commitments	\$3,235,250	\$ 10,216	2008
Forward agency and loan sales	3,051,882	21,180	2008
Mortgage servicing rights derivatives:			
Treasury and agency futures	920,000	(19,802)	2008
Treasury options	1,700,000	(24,316)	2008
Borrowings and advances derivatives:			
Interest rate swaps (LIBOR)	130,000	(149)	2008-2010

	<b>December 31, 2007</b>		
	<b>Notional Amounts</b>	<b>Fair Value</b>	<b>Expiration Dates</b>
Mortgage banking derivatives:			
Rate lock commitments	\$3,069,134	\$ 26,129	2008
Forward agency and loan sales	3,845,065	(13,504)	2008
Borrowings and advances hedges:			
Interest rate swaps (LIBOR)	130,000	378	2008-2010

**Counterparty Credit Risk**

The Bank is exposed to credit loss in the event of non-performance by the counterparties to its various derivative financial instruments. The Company attempts to manage this risk by selecting large, well-established counterparties, spreading the credit risk among such counterparties, and by placing contractual limits on the amount of unsecured credit risk from any single counterparty.

**Note 12. Stock-Based Compensation**

For the three months ended September 30, 2008 and 2007, the Company recorded stock-based compensation expense of \$0.5 million (\$0.4 million net of tax) and \$0.4 million (\$0.3 million net of tax), respectively. For the nine months ended September 30, 2008 and 2007, the Company recorded stock-based compensation expense of \$1.4 million (\$0.9 million net of tax) and \$1.1 million (\$0.7 million net of tax), respectively.

**Stock Options**

During the three month periods ended September 30, 2008 and 2007, there were no stock options granted.



**Table of Contents****Cash-Settled Stock Appreciation Rights**

The Company issues cash-settled stock appreciation rights ( SAR ) to officers and key employees in connection with year-end compensation. Cash-settled stock appreciation rights generally vest at the rate of 25% of the grant on each of the first four annual anniversaries of the grant date. The standard term of a SAR is seven years beginning on the grant date. Grants of SARs may be settled only in cash and once made, may not be later amended or modified to be settled in common stock or a combination of common stock and cash. There were no SARs issued during the third quarter of 2008 or 2007.

**Restricted Stock**

The Company issued restricted stock to officers, directors, and key employees in connection with year-end compensation. Restricted stock generally will vest in 50% increments on each annual anniversary following the date of grant. The Company incurred expenses during the three month periods ended September 30, 2008 and 2007 of approximately \$0.4 million and \$0.3 million, respectively. During the nine month periods ended September 30, 2008 and 2007, the Company incurred expenses of approximately \$1.1 million and \$0.9 million, respectively.

**Note 13. Segment Information**

The Company's operations are broken down into two business segments: banking and home lending. Each business operates under the same banking charter but is reported on a segmented basis for this report. Each of the business lines is complementary to each other. The banking operation includes the gathering of deposits and investing those deposits in duration-matched assets primarily originated by the home lending operation. The banking group holds these loans in the investment portfolio in order to earn income based on the difference or spread between the interest earned on loans and the interest paid for deposits and other borrowed funds. The home lending operation involves the origination, packaging, and sale of loans in order to receive transaction income. The lending operation also services mortgage loans for others and sells MSRs into the secondary market. Funding for the lending operation is provided by deposits and borrowings garnered by the banking group. All of the non-bank consolidated subsidiaries are included in the banking segment. No such subsidiary is material to the Company's overall operations.

Following is a presentation of financial information by segment for the periods indicated (in thousands):

**For the Three Months Ended September 30, 2008**

	<b>Bank Operations</b>	<b>Home Lending Operations</b>	<b>Elimination</b>	<b>Combined</b>
<b>2008:</b>				
Net interest income	\$ 45,609	\$ 14,232	\$	\$ 59,841
Gain on sale revenue		23,048		23,048
Other (loss) income	(2,552)	32,892		30,340
Total net interest income and non-interest income	43,057	70,172		113,229
Loss before federal income taxes	(85,707)	(9,840)		(95,547)
Depreciation and amortization	2,414	4,911		7,325
Capital expenditures	3,566	3,362		6,928
Identifiable assets	13,345,151	3,099,218	(2,285,000)	14,159,369
Inter-segment income (expense)	17,138	(17,138)		

**For the Nine Months Ended September 30, 2008**

	<b>Bank Operations</b>	<b>Home Lending Operations</b>	<b>Elimination</b>	<b>Combined</b>
<b>2008:</b>				
Net interest income	\$ 116,428	\$ 59,610	\$	\$ 176,038
Gain on sale revenue		129,751		129,751
Other income	16,204	60,385		76,589

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Total net interest income and non-interest income	132,632	249,746		382,378
(Loss) earnings before federal income taxes	(137,681)	50,283		(87,398)
Depreciation and amortization	6,893	12,071		18,964
Capital expenditures	13,967	10,259		24,226
Identifiable assets	13,345,151	3,099,218	(2,285,000)	14,159,369
Inter-segment income (expense)	59,738	(59,738)		
	25			

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**Table of Contents****For the Three Months Ended September 30, 2007**

	<b>Bank</b>	<b>Home</b>		
<b>2007:</b>	<b>Operations</b>	<b>Lending</b>	<b>Elimination</b>	<b>Combined</b>
Net interest income	\$ 23,806	\$ 30,130	\$	\$ 53,936
Gain on sale revenue		(17,001)		(17,001)
Other income	10,056	8,213		18,269
Total net interest income and non-interest income	33,862	21,342		55,204
(Loss) earnings before federal income taxes	(24,469)	(23,782)		(48,251)
Depreciation and amortization	2,482	21,815		24,297
Capital expenditures	4,437	6,633		11,070
Identifiable assets	15,879,011	6,175,988	(5,490,000)	16,564,999
Inter-segment income (expense)	41,175	(41,175)		

**For the Nine Months Ended September 30, 2007**

	<b>Bank</b>	<b>Home</b>		
<b>2007:</b>	<b>Operations</b>	<b>Lending</b>	<b>Elimination</b>	<b>Combined</b>
Net interest income	\$ 87,819	\$ 68,006	\$	\$ 155,825
Gain on sale revenue		42,022		42,022
Other income	39,261	17,327		56,588
Total net interest income and non-interest income	127,080	127,355		254,435
(Loss) earnings before federal income taxes	(8,877)	(3,521)		(12,398)
Depreciation and amortization	7,466	64,226		71,692
Capital expenditures	20,267	5,616		25,883
Identifiable assets	15,879,011	6,175,988	(5,490,000)	16,564,999
Inter-segment income (expense)	105,233	(105,233)		

**Note 14. Private Placement**

The Company entered into purchase agreements with seven institutional investors, Thomas J. Hammond, Chairman of the Company and Mark T. Hammond, Vice Chairman, President and Chief Executive Officer of the Company effective May 16, 2008. Pursuant to the terms of the purchase agreements, the Company raised, in aggregate, approximately \$100 million in cash or \$94 million net of placement agent and legal fees, through direct sales to investors of the Company.

Under the terms of the purchase agreements, institutional investors agreed to purchase up to 11,365,000 shares of the Company's common stock at \$4.25 per share, and Thomas Hammond and Mark Hammond agreed to purchase 635,000 shares of the Company's common stock at \$5.88 per share. Additionally, the Company issued 47,982 shares of mandatory convertible non-cumulative perpetual preferred stock to the institutional investors at a purchase price and liquidation preference of \$1,000 per share. Upon approval by the Company's stockholders, the preferred shares automatically convert to 11,289,878 shares of the Company's common stock at an initial conversion price of \$4.25 per share.

The offering was finalized on May 19, 2008, whereby a total of approximately \$100 million of gross proceeds, or \$94 million in net proceeds, were received. The Company invested \$72 million into the Bank for working capital purposes and the remaining \$22 million remained at the Company to be used to service long term debt payments.



A Special Meeting of Stockholders to vote on the approval of the conversion of the preferred shares to common shares was held on August 12, 2008. On that date, the shareholders approved the conversion of the Company's mandatory convertible non-cumulative perpetual preferred stock into the Company's common stock. The preferred stock automatically converted into shares of common stock as a result.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Where we say we, us, or our, we usually mean Flagstar Bancorp, Inc. In some cases, a reference to we, us, or our will include our wholly-owned subsidiary Flagstar Bank, FSB, and Flagstar Capital Markets Corporation, its wholly-owned subsidiary, which we collectively refer to as the Bank.

#### **General**

Operations of the Bank are categorized into two business segments: banking and home lending. Each segment operates under the same banking charter, but is reported on a segmented basis for financial reporting purposes. For certain financial information concerning the results of operations of our banking and home lending operations, see Note 13 of the Notes to Consolidated Financial Statements, in Item 1, Financial Statements, herein.

**Banking Operation.** We provide a broad range of banking services to consumers, small businesses and municipalities in Michigan, Indiana and Georgia as well as to across the country through our internet banking operations. Our banking operation involves the gathering of deposits and investing those deposits in duration-matched assets consisting primarily of mortgage loans originated by our home lending operation. The banking operation holds these loans in its loans held for investment portfolio in order to earn income based on the difference, or spread, between the interest earned on loans and investments and the interest paid for deposits and other borrowed funds. At September 30, 2008, we operated a network of 173 banking centers and provided banking services to approximately 129,100 households. During the third quarter of 2008, we opened three banking centers in Georgia. During the first nine months of 2008, we consolidated an in-store Indiana branch into an existing traditional branch. During October 2008, we opened one additional branch in the Atlanta, Georgia area and one additional branch in Michigan. We do not expect to open any additional branches during the fourth quarter 2008.

**Home Lending Operation.** Our home lending operation originates, acquires, securitizes and sells residential mortgage loans on one-to-four family residences in order to generate transactional income. The home lending operation also services mortgage loans on a fee basis for others and occasionally sells mortgage servicing rights into the secondary market. Funding for our home lending operation is provided primarily by deposits and borrowings obtained by our banking operation.

#### **Critical Accounting Policies**

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, we have identified five policies that, due to the judgment, estimates and assumptions inherent in those policies, are critical to an understanding of our consolidated financial statements. These policies relate to: (a) the determination of our allowance for loan losses; (b) the valuation of our MSRs; (c) the valuation of our residuals; (d) the valuation of our derivative instruments; and (e) the determination of our secondary market reserve. We believe that the judgment, estimates and assumptions used in the preparation of our consolidated financial statements are appropriate given the factual circumstances at the time. However, given the sensitivity of our consolidated financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. For further information on our critical accounting policies, please refer to our Annual Report on Form 10-K for the year ended December 31, 2007, which is available on our website, [www.flagstar.com](http://www.flagstar.com), under the Investor Relations section, or on the website of the SEC, at [www.sec.gov](http://www.sec.gov).

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**Selected Financial Ratios**  
**(Dollars in thousands, except per share data)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Return on average assets	(1.72)%	(0.77)%	(0.50)%	(0.08)%
Return on average equity	(32.15)%	(17.08)%	(10.29)%	(1.57)%
Efficiency ratio	105.2%	132.7%	79.0%	85.2%
Equity/assets ratio (average for the period)	5.34%	4.51%	4.88%	4.79%
Mortgage loans originated or purchased	\$6,680,450	\$6,566,185	\$22,600,324	\$19,218,370
Other loans originated or purchased	\$ 34,666	\$ 262,415	\$ 301,420	\$ 785,169
Mortgage loans sold	\$6,809,608	\$5,955,396	\$22,076,479	\$16,975,645
Interest rate spread Bank only <sup>1</sup>	1.78%	1.35%	1.69%	1.29%
Net interest margin Bank only <sup>2</sup>	1.93%	1.52%	1.84%	1.45%
Interest rate spread Consolidated	1.74%	1.27%	1.64%	1.29%
Net interest margin Consolidated <sup>2</sup>	1.82%	1.36%	1.73%	1.38%
Dividend payout ratio	N/A	(18.8)%	N/A	(197.3)%
Average common shares outstanding	78,473	60,265	68,301	61,450
Average fully diluted shares outstanding	78,473	60,636	68,301	61,874
Charge-offs to average investment loans	0.83%	0.33%	0.71%	0.34%
	<b>September 30,</b>	<b>June 30,</b>	<b>December 31,</b>	<b>September 30,</b>
	<b>2008</b>	<b>2008</b>	<b>2007</b>	<b>2007</b>
Equity-to-assets ratio	4.78%	5.49%	4.39%	4.40%
Core capital ratio <sup>3</sup>	6.29%	6.70%	5.78%	5.78%
Total risk-based capital ratio <sup>3</sup>	11.10%	11.65%	10.66%	10.65%
Book value per common share	\$ 8.09	\$ 10.45 <sup>(4)</sup>	\$ 11.50	\$ 12.09
Number of common shares outstanding	83,627	72,337	60,271	60,271
Mortgage loans serviced for others	\$51,830,707	\$45,830,865	\$32,487,337	\$26,665,052
Capitalized value of mortgage servicing rights	1.41%	1.47%	1.27%	1.28%
Ratio of allowance to non-performing loans	54.1%	46.3%	52.8%	61.0%
Ratio of allowance to loans held for investment	2.45%	1.69%	1.28%	1.11%
Ratio of non-performing assets to total assets	3.87%	3.17%	1.90%	1.34%
Number of banking centers	173	170	164	158
Number of home lending centers	111	121	143	151
Number of salaried employees	3,291	3,389	3,083	2,939
Number of commissioned employees	736	791	877	852

(1)

Interest rate spread is the difference between the annualized average yield earned on average interest-earning assets for the period and the annualized average rate of interest paid on average interest-bearing liabilities for the period.

- (2) Net interest margin is the annualized effect of the net interest income divided by that period's average interest-earning assets.
- (3) Based on adjusted total assets for purposes of tangible capital and core capital, and risk-weighted assets for purposes of risk-based capital and total risk based capital. These ratios are applicable to the Bank only.
- (4) The book value per common share assuming the conversion

of the  
Company's  
mandatory  
convertible  
non-cumulative  
perpetual  
preferred stock,  
series A at  
June 30, 2008  
was \$9.54.

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**Results of Operations**

**Net Loss**

*Three Months.* Net loss for the three months ended September 30, 2008 was \$(62.1) million, \$(0.79) per share-diluted, a \$30.0 million decrease from the loss of \$(32.1) million, \$(0.53) per share-diluted, reported in the comparable 2007 period. The overall decrease on a pretax basis resulted primarily from a \$52.1 million increase in non-interest income and a \$5.9 million increase in net interest income before provision offset by a \$59.4 million increase in the provision for loan losses and a \$45.9 million increase in non-interest expense.

*Nine Months.* Net loss for the nine months ended September 30, 2008 was \$(56.9) million, \$(0.83) per share-diluted, a \$47.7 million decrease from the loss of \$(9.2) million, \$(0.15) per share-diluted, reported in the comparable 2007 period. The overall decrease on a pretax basis resulted from a \$107.7 million increase in non-interest income and a \$20.2 million increase in net interest income before provision offset by a \$117.8 million increase in the provision for loan losses and an \$85.2 million increase in non-interest expense.

**Net Interest Income**

*Three Months.* We recorded \$59.8 million in net interest income before provision for loan losses for the three months ended September 30, 2008, a 10.9% increase from \$53.9 million recorded for the comparable 2007 period. The increase reflects a \$48.6 million decrease in interest income offset by a \$54.5 million decrease in interest expense, primarily as a result of rates paid on deposits, FHLB advances and security repurchase agreements that decreased more than the decrease in yields earned on loans and securities. The increase in net interest income before provision for loan losses in the three months ended September 30, 2008, as compared to the same period in 2007, resulted despite a decrease of our average interest-earning assets by \$2.8 billion and our average interest-paying liabilities by \$2.4 billion.

Average interest-earning assets as a whole repriced down 28 basis points during the three months ended September 30, 2008 and average interest-bearing liabilities repriced down 75 basis points during the same period, resulting in the increase in our interest rate spread of 47 basis points to 1.74% for the three months ended September 30, 2008, from 1.27% for the comparable 2007 period. The Company recorded a net interest margin of 1.82% at September 30, 2008 as compared to 1.36% at September 30, 2007. At the Bank level, the net interest margin was 1.93% at September 30, 2008, as compared to 1.52% at September 30, 2007.

*Nine Months.* We recorded \$176.0 million in net interest income before provision for loan losses for the nine months ended September 30, 2008, a 13.0% increase from \$155.8 million recorded for the comparable 2007 period. The increase reflects an \$80.2 million decrease in interest income offset by a \$100.5 million decrease in interest expense. The increase in net interest income before provision for loan losses in the nine months ended September 30, 2008, as compared to the same period in 2007, resulted despite a decrease of our average interest-earning assets by \$1.5 billion and our average interest-paying liabilities by \$1.3 billion.

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**Average Yields Earned and Rates Paid.** The following table presents interest income from average interest-earning assets, expressed in dollars and yields, and interest expense on average interest-bearing liabilities, expressed in dollars and rates at the Company. Interest income from earning assets includes the amortization of net premiums and net deferred loan origination costs of \$1.9 million and \$5.2 million for the three months ended September 30, 2008 and 2007 and \$8.5 million and \$19.3 million for the nine months ended September 30, 2008 and 2007, respectively. Non-accruing loans were included in the average loan amounts outstanding.

	Three Months Ended September 30,					
	Average Balance	2008 Interest	Annualized Yield/Rate (Dollars in thousands)	Average Balance	2007 Interest	Annualized Yield/Rate
<b>Interest-earning assets:</b>						
Loans available for sale	\$ 2,196,230	\$ 40,063	7.14%	\$ 5,680,959	\$ 88,510	6.23%
Loans held for investment	9,403,920	132,100	5.52%	7,131,286	112,954	6.34%
Mortgage-backed securities held to maturity				1,207,941	15,485	5.09%
Securities classified as available for sale or trading	981,804	14,563	5.90%	1,021,178	15,212	4.94%
Interest-bearing deposits	258,122	1,416	2.18%	528,857	3,647	2.74%
Other	30,427	395	5.16%	124,713	1,343	4.27%
Total interest-earning assets	12,870,503	188,537	5.76%	15,694,934	237,151	6.04%
Other assets	1,598,395			954,882		
Total assets	\$ 14,468,898			\$ 16,649,816		
<b>Interest-bearing liabilities</b>						
Deposits	\$ 6,640,749	60,940	3.65%	\$ 7,715,971	91,117	4.69%
FHLB advances	5,723,217	62,348	4.33%	5,978,691	70,534	4.68%
Federal Reserve borrowings	73,837	419	2.26%			
Security repurchase agreements	108,000	1,179	4.34%	1,299,963	17,982	5.49%
Other	248,661	3,810	6.00%	238,399	3,582	6.01%
Total interest-bearing liabilities	12,794,464	128,696	4.02%	15,233,024	183,215	4.77%
Other liabilities	901,824			666,222		
Stockholders' equity	772,610			750,570		
Total liabilities and stockholders' equity	\$ 14,468,898			\$ 16,649,816		

Net interest-earning assets	\$ 76,039	\$ 461,910	
Net interest income	\$ 59,841	\$ 53,936	
Interest rate spread <sup>1</sup>	1.74%	1.27%	
Net interest margin <sup>2</sup>	1.82%	1.36%	
Ratio of average interest-earning assets to average interest-bearing liabilities	101%	103%	

(1) Interest rate spread is the difference between the annualized average yield earned on average interest-earning assets for the period and the annualized average rate of interest paid on average interest-bearing liabilities for the period.

(2) Net interest margin is the annualized effect of the net interest income divided by that period's average interest-earning assets.



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	Nine Months Ended September 30,					
	Average Balance	2008 Interest	Annualized Yield/Rate (Dollars in thousands)	Average Balance	2007 Interest	Annualized Yield/Rate
<b>Interest-earning assets:</b>						
Loans available for sale	\$ 2,761,351	\$ 141,551	6.74%	\$ 4,578,248	\$ 211,846	6.17%
Loans held for investment	8,978,992	384,488	5.65%	7,973,853	366,827	6.13%
Mortgage-backed securities held to maturity	400,169	15,576	5.20%	1,214,867	43,869	4.83%
Securities classified as available for sale	1,185,921	51,325	5.78%	910,556	42,334	6.22%
Interest-bearing deposits	254,227	5,561	2.92%	292,631	9,823	4.49%
Other	28,907	1,453	6.71%	92,988	5,486	7.89%
Total interest-earning assets	13,609,567	599,954	5.82%	15,063,143	680,185	6.02%
Other assets	1,528,888			1,168,393		
Total assets	\$ 15,138,455			\$ 16,231,536		
<b>Interest-bearing liabilities</b>						
Deposits	\$ 7,153,942	215,807	4.03%	\$ 7,592,261	262,181	4.62%
FHLB advances	5,917,985	190,168	4.29%	5,800,591	203,268	4.69%
Federal Reserve borrowings	28,631	484	2.26%			
Security repurchase agreements	184,873	5,541	4.00%	1,191,851	48,416	5.43%
Other	248,677	11,916	6.30%	218,175	10,495	6.41%
Total interest-bearing liabilities	13,534,108	423,916	4.18%	14,802,878	524,360	4.73%
Other liabilities	866,208			651,669		
Stockholders' equity	738,139			776,989		
Total liabilities and stockholders' equity	\$ 15,138,455			\$ 16,231,536		
Net interest-earning assets	\$ 75,459			\$ 260,265		
Net interest income		\$ 176,038			\$ 155,825	
Interest rate spread <sup>1</sup>			1.64%			1.29%

Net interest margin <sup>2</sup>	1.73%	1.38%
Ratio of average interest-earning assets to average interest-bearing liabilities	101%	102%

- (1) Interest rate spread is the difference between the annualized average yield earned on average interest-earning assets for the period and the annualized average rate of interest paid on average interest-bearing liabilities for the period.
- (2) Net interest margin is the annualized effect of the net interest income divided by that period's average interest-earning assets.

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**Rate/Volume Analysis.** The following table presents the dollar amount of changes in interest income and interest expense for the components of interest-earning assets and interest-bearing liabilities, which are presented in the preceding table. The table below distinguishes between the changes related to average outstanding balances (changes in volume while holding the initial rate constant) and the changes related to average interest rates (changes in average rates while holding the initial balance constant). Changes attributable to both a change in volume and a change in rates are included as changes in rate.

Three Months Ended September 30, 2008 Versus 2007			
	Increase (Decrease) due to:		
	Rate	Volume	Total
	(In thousands)		
<b>Interest-earning assets:</b>			
Loans available for sale	\$ 5,828	\$ (54,275)	\$ (48,447)
Loans held for investment	(16,876)	36,022	19,146
Mortgage-backed securities-held to maturity	(114)	(15,371)	(15,485)
Securities classified as available for sale	(163)	(486)	(649)
Interest-earning deposits	(376)	(1,855)	(2,231)
Other	60	(1,008)	(948)
Total	(11,641)	(36,973)	(48,614)
<b>Interest-bearing liabilities:</b>			
Deposits	(17,639)	(12,538)	(30,177)
FHLB advances	(5,213)	(2,973)	(8,186)
Federal Reserve borrowings	419		419
Security repurchase agreements	(533)	(16,270)	(16,803)
Other	75	153	228
Total	(22,891)	(31,628)	(54,519)
<b>Change in net interest income</b>	<b>\$ 11,250</b>	<b>\$ (5,345)</b>	<b>\$ 5,905</b>

	Nine Months Ended September 30, 2008 Versus 2007		
	Increase (Decrease) due to:		
	Rate	Volume	Total
	(In thousands)		
Interest-earning assets:			
Loans available for sale	\$ (32,927)	\$ (37,368)	\$ (70,295)
Loans held for investment	(2,877)	20,538	17,661
Mortgage-backed securities-held to maturity	(15,176)	(13,117)	(28,293)
Securities classified as available for sale	3,282	5,709	8,991
Interest-earning deposits	(3,687)	(575)	(4,262)
Other	(2,348)	(1,685)	(4,033)
Total	(53,733)	(26,498)	(80,231)

**Interest-bearing liabilities:**

Deposits	(31,269)	(15,105)	(46,374)
FHLB advances	(17,207)	4,107	(13,100)
Federal Reserve borrowings	484		484
Security repurchase agreements	(2,090)	(40,785)	(42,875)
Other	(37)	1,458	1,421
Total	(50,119)	(50,325)	(100,444)

<b>Change in net interest income</b>	\$ (3,614)	\$ 23,827	\$ 20,213
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**Provision for Loan Losses**

*Three Months.* During the three months ended September 30, 2008, we recorded a provision for loan losses of \$89.6 million as compared to \$30.2 million recorded during the same period in 2007. The provision reflects our estimate to

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maintain the allowance for loan losses at a level management believes is appropriate to cover probable and inherent losses in the portfolio and had the effect of increasing our allowance for loan losses by \$70.0 million for the three month period ended September 30, 2008. Net charge-offs increased in the 2008 period to \$19.6 million, compared to \$5.8 million for the same period in 2007, and as a percentage of investment loans, increased to an annualized 0.83% from 0.33%. The increase in charge-offs as a percentage of investment loans reflects the Bank's decline in credit quality reflected in increases in net charge-offs and non-performing loans. See Analysis of Items on Statement of Financial Condition Assets Allowance for Loan Losses, below, for further information.

*Nine Months.* During the nine months ended September 30, 2008, we recorded a provision for loan losses of \$167.7 million as compared to \$49.9 million recorded during the same period in 2007. The provision reflects our estimate to maintain the allowance for loan losses at a level management believes is appropriate to cover probable and inherent losses in the portfolio. It had the effect of increasing our allowance for loan losses by \$120.0 million. Net charge-offs increased in the 2008 period to \$47.7 million, compared to \$17.9 million for the same period in 2007, and as a percentage of investment loans, increased to an annualized 0.71% from 0.34%. The increase in charge-offs as a percentage of investment loans reflects the Bank's decline in credit quality as reflected in increases in net charge-offs and non-performing loans. See Analysis of Items on Statement of Financial Condition Assets Allowance for Loan Losses, below, for further information.

**Non-Interest Income**

Our non-interest income consists of (i) loan fees and charges, (ii) deposit fees and charges, (iii) loan administration, (iv) net gain (loss) on loan sales, (v) net gain on sales of MSRs, (vi) net gain (loss) on sales of securities available for sale, (vii) loss (gain) on trading securities and (viii) other fees and charges. During the three months ended September 30, 2008, non-interest income increased to \$53.4 million from \$1.3 million in the comparable 2007 period. During the nine months ended September 30, 2008, non-interest income increased to \$206.3 million from \$98.6 million in the comparable 2007 period.

***Loan Fees and Charges.*** Both our home lending operation and banking operation earn loan origination fees and collect other charges in connection with originating residential mortgages and other types of loans.

*Three months.* Loan fees recorded during the three months ended September 30, 2008 totaled \$0.8 million compared to a loss of \$0.2 million recorded during the comparable 2007 period. This increase is the result of the increase in non-capitalizable fees during the period as a result of an increase in our mortgage loan production.

*Nine months.* Loan fees recorded during the nine months ended September 30, 2008 totaled \$2.3 million compared to \$1.3 million recorded during the comparable 2007 period. This increase is the result of the increase in non-capitalizable fees during the year as a result of an increase in our mortgage loan production.

***Deposit Fees and Charges.*** Our banking operation records deposit fees and other charges such as fees for non-sufficient funds checks, cashier check fees, ATM fees, overdraft protection, and other account fees for services we provide to our banking customers.

*Three months.* During the three months ended September 30, 2008, we recorded \$7.2 million in deposit fees versus \$5.8 million in the comparable 2007 period. This increase is attributable to the increase in our non-sufficient funds fees and other depository fees as our banking franchise continues to expand.

*Nine months.* During the nine months ended September 30, 2008, we recorded \$20.0 million in deposit fees versus \$16.5 million recorded in the comparable 2007 period. This increase is attributable to the increase in our non-sufficient funds fees and other depository fees as our banking franchise continues to expand.

***Loan Administration.*** When our home lending operation sells mortgage loans in the secondary market it usually retains the right to continue to service these loans and earn a servicing fee. Until January 1, 2008, our MSRs were accounted for on the amortization method; thereafter, the majority of our MSRs have been accounted for on the fair value method. See Note 9 Mortgage Servicing Rights, in Item 1. Financial Statements, herein.

*Three Months.* The loan administration income during the three month period ended September 30, 2008 increased to \$25.7 million from \$4.3 million during the comparable 2007 period. During 2008, we recorded revenues from servicing fees and ancillary income of \$41.0 million offset by a mark to market adjustment of \$14.8 million on the fair value of the residential MSRs and amortization on consumer mortgage servicing of \$0.6 million. The mark to market adjustment was net of hedging losses of \$14.4 million.

Included in our results of loan administration for both the three month and nine month periods ended September 30, 2008 is the effect of the failure of Lehman Brothers in September 2008 to honor its commitment to buy \$65.0 million of excess servicing. The asset was sold in late August for late September settlement and was removed from the hedged position. In mid-September, we received confirmation of Lehman's.

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failure to follow through on its commitment to purchase the asset. The asset was re-bid for indicative levels at that time at a \$17.1 million reduction in value and the incremental exposure was subsequently re-hedged.

**Nine Months.** The loan administration income during the nine month period ended September 30, 2008 increased to \$46.0 million from \$10.1 million during the comparable 2007 period. During 2008, we recorded revenues from servicing fees and ancillary income of \$106.7 million which was offset by amortization on consumer mortgage servicing of \$1.9 million and a mark to market adjustment of \$58.8 million on the fair value of the residential MSRs. The mark to market adjustment was net of hedging losses of \$42.3 million. Although the fair value method of accounting was adopted effective January 1, 2008, we did not begin hedging the portfolio until the latter portion of the first quarter. During the 2007 period, we recorded revenues from servicing fees and ancillary income of \$59.8 million which was offset by amortization of \$52.7 million. The increase in the servicing fees and ancillary income in the 2008 period is due to the significant increase in the loans serviced during the 2008 period over the corresponding period in 2007. The total unpaid principal balance of loans serviced for others was \$51.8 billion at September 30, 2008, versus \$32.5 billion serviced at December 31, 2007, and \$26.7 billion serviced at September 30, 2007.

**Net Gain (Loss) on Loan Sales.** Our home lending operation records the transaction fee income it generates from the origination, securitization, and sale of mortgage loans in the secondary market. The amount of net gain on loan sales recognized is a function of the volume of mortgage loans sold and the gain on sale spread achieved, net of related selling expenses. Net gain on loan sales is also increased or decreased by any mark to market pricing adjustments on loan commitments and forward sales commitments in accordance with SFAS 133, *Accounting for Derivative Instruments* ( SFAS 133 ), increases to the secondary market reserve related to loans sold during the period, and related administrative expenses. The volatility in the gain on sale spread is attributable to market pricing, which changes with demand and the general level of interest rates. Generally, we are able to sell loans into the secondary market at a higher margin during periods of low or decreasing interest rates. Typically, as the volume of acquirable loans increases in a lower or falling interest rate environment, we are able to pay less to acquire loans and are then able to achieve higher spreads on the eventual sale of the acquired loans. In contrast, when interest rates rise, the volume of acquirable loans decreases and therefore we may be required to pay more in the acquisition phase, thus decreasing our net gain achievable. During 2008, our net gain was also affected by increasing spreads available from securities we sell that are guaranteed by Fannie Mae and Freddie Mac and by a combination of a significant decline in residential mortgage lenders and a significant shift in loan demand to Fannie Mae and Freddie Mac conforming residential mortgage loans and Ginnie Mae-insured loans, which has provided us with loan pricing opportunities for conventional residential mortgage products.

The following table indicates the net gain on loan sales reported in our consolidated financial statements to our loans sold or securitized within the period (dollars in thousands):

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net (loss) gain on loan sales	\$ 22,152	\$ (17,457)	\$ 129,403	\$ 35,841
Loans sold or securitized	\$6,809,608	\$5,955,396	\$22,076,479	\$16,975,645
Spread achieved	0.33%	(0.29)%	0.59%	0.21%

**Three months.** For the three months ended September 30, 2008, there was a net gain (loss) on loan sales of \$22.2 million, as compared to a loss of \$17.5 million in the 2007 period, an increase of \$39.7 million. The 2008 period reflects the sale of \$6.8 billion in loans versus \$6.0 billion sold in the 2007 period. Management believes changes in market conditions during the 2008 period resulted in a slight increase in mortgage loan origination volume (\$6.7 billion in the 2008 period vs. \$6.6 billion in the 2007 period), allowing for increased sales in the third quarter of 2008, and an increased net gain (loss) on sale spread (33 basis points in the 2008 period versus a negative 29 basis

points in the 2007 period).

Our calculation of net gain on loan sales reflects gross gains on loan sales, changes in amounts related to SFAS 133, lower of cost or market adjustments on loans transferred to held for investment and provisions to our secondary market reserve. Changes in amounts related to SFAS 133 amounted to \$8.2 million and \$8.5 million for the three months ended September 30, 2008 and 2007, respectively. Lower of cost or market adjustments amounted to \$12.0 million and \$0.1 million for the three months ended September 30, 2008 and 2007, respectively. Provisions to our secondary market reserve amounted to \$2.4 million and \$2.7 million, for the three months ended September 30, 2008 and 2007, respectively. Also included in our net gain (loss) on loan sales is the capitalized value of our MSRs, which totaled \$85.5 million and \$93.6 million for the three months ended September 30, 2008 and 2007, respectively.

*Nine months.* For the nine months ended September 30, 2008, net gain on loan sales increased \$93.6 million to \$129.4 million from the \$35.8 million in the 2007 period. The 2008 period reflects the sale of \$22.1 billion in loans versus \$17.0 billion sold in the 2007 period. Management believes changes in market conditions during the 2007 period resulted in



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an increased mortgage loan origination volume (\$22.6 billion in the 2008 period versus \$19.2 billion in the 2007 period) and a higher overall gain on sale spread (59 basis points in the 2008 versus 21 basis points in the 2007 period).

Our calculation of net gain on loan sales reflects gross gains on loan sales, changes in amounts related to SFAS 133, lower of cost or market adjustments on loans transferred to held for investment and provisions to our secondary market reserve. Changes in amounts related to SFAS 133 amounted to \$18.8 million and \$0.9 million for the nine months ended September 30, 2008 and 2007, respectively. Lower of cost or market adjustments amounted to \$34.7 million and \$0.2 million for the nine months ended September 30, 2008 and 2007, respectively. Provisions to our secondary market reserve amounted to \$8.2 million and \$7.2 million, for the nine months ended September 30, 2008 and 2007, respectively. Also included in our net gain on loan sales is the capitalized value of our MSR, which totaled \$292.0 million and \$247.5 million for the nine months ended September 30, 2008 and 2007, respectively.

***Net Gain on Sales of Mortgage Servicing Rights.*** As part of our business model, our home lending operation occasionally sells MSRs from time to time in transactions separate from the sale of the underlying loans. Prior to 2008, at the time of the MSR sale, we record a gain or loss based on the selling price of the MSRs less our carrying value and transaction costs. Accordingly, the amount of net gains on MSR sales depends upon the gain on sale spread and the volume of MSRs sold. The spread is attributable to market pricing, which changes with demand and the general level of interest rates. Effective January 1, 2008, with the adoption of fair value accounting for MSRs, we would not expect to realize significant gains or losses at the time of sale. Instead, our income from MSRs would be recorded through loan administration income.

***Three months.*** During the three month period ending September 30, 2008 and 2007, we did not sell any servicing rights on a bulk basis. For the three months ended September 30, 2008, we recognized a gain of \$0.9 million on our change in the estimate of amounts receivable from past MSR sales. The \$0.5 million gain on MSR sales for the three months ended September 30, 2007 resulted from the \$95.5 million of servicing rights sold on a servicing released basis during that period.

***Nine months.*** During the nine month period ending September 30, 2008, we did not sell any servicing rights on a bulk basis; however, for the same period in 2007 we sold servicing rights related to \$2.0 billion of loans serviced for others on a bulk basis. For the nine months ended September 30, 2008, we recognized a gain of \$0.3 million on our change in estimate of amounts receivable from past MSR sales.

***Net (Loss) Gain on Sales of Securities Available for Sale.*** Securities classified as available for sale are comprised of U.S. government sponsored agency securities as well as non-agency securities. During 2007, securities classified as available for sale also included certain residual interests from private securitizations.

***Three Months.*** Gains (losses) on the sale of agency securities available for sale that are recently created with underlying mortgage products originated by Flagstar are reported within net gain on loan sale. Securities in this category have typically remained in the portfolio less than 30 days before sale. During the three months ended September 30, 2008, sales of these agency securities with underlying mortgage products originated by Flagstar were \$36.4 million resulting in \$172,000 of net gain on loan sale.

During the three months ended September 30, 2008, we sold \$13.8 million in available for sale securities consisting of agency securities. Gain (loss) on sales for these available for sale securities types are reported in net gain on sale of available for sale securities. These sales generated a \$149,000 net gain on sale of available for sale securities.

During the three months ended September 30, 2007, we sold \$84.2 million of securities available for sale which resulted in gains of \$668,000. Also, during the three months ended September 30, 2007, we had a \$3.6 million other-than-temporary impairment of our residual interests that arose from securitizations completed in 2005 and 2006. The other-than-temporary impairment arose during the third quarter of 2007 primarily from the increase in our credit loss assumptions for these securitizations.

The increase was caused by our recognition of the increasing losses in the underlying mortgages. The credit loss assumptions have increased by as much as 80% for certain securitizations.

***Nine Months.*** During the nine months ended September 30, 2008, sales of agency securities with underlying mortgage products originated by Flagstar were \$2.8 billion resulting in \$1.7 million of net gain on loan sale. There were no such sales in the nine months ended September 30, 2007.

During the nine months ended September 30, 2008, we sold \$908.8 million in available for sales securities consisting of agency securities. These sales generated a \$5.0 million net gain on sale of available for sale securities. In the nine months ended

September 30, 2007, we sold \$255.2 million in purchased agency and non-agency securities available for sale. These sales generated net gains on sale of available for sale securities of \$1.4 million. During the nine months ended September 30, 2007, we recognized a \$3.6 million other-than-temporary impairment as described above. In 2008, such losses are recognized as (loss) gain on trading securities.

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***(Loss) Gain on Trading Securities.*** Securities classified as trading are comprised of residual interests from private-label securitizations. (Loss) gain on securities classified as trading is the result of a change in the estimated fair value of the securities.

***Three Months.*** During the three months ended September 30, 2008, we recorded a \$12.9 million loss on trading securities. The loss was primarily due to the increase in the estimated cumulative loss expectations which were only partially offset by the changes to prepayment speeds related to the loans underlying the residual interests. Additionally, during the third quarter certain of these assets were affected by the tightening of the spread between LIBOR and prime interest rates. These changes caused a reduction in the fair value of the residual interests from our private-label securitizations.

During the three and nine months ended September 30, 2007, we recognized an unrealized gain on trading securities of \$1.9 million. Although certain assumptions relating to these residual interests were negatively adjusted during the third quarter of 2007, the value of these residual interests increased based on the reduction in interest rate paid to the senior investors. A significant portion of the bonds issued in the securitization are variable rate and as such the reduction of the interest rate on such bonds results in additional expected cash flow available to residual interests.

***Nine Months.*** During the nine months ended September 30, 2008, we recorded a \$26.5 million loss on trading securities. The loss was primarily due to the increase in the estimated cumulative loss expectations which were only partially offset by the changes to prepayment speeds related to the loans underlying the residual interests. These changes caused a reduction in the fair value of the residual interests from our private-label securitizations.

***Other Fees and Charges.*** Other fees and charges include certain miscellaneous fees, including dividends received on FHLB stock and income generated by our subsidiaries.

***Three months.*** During the three months ended September 30, 2008, we recorded \$4.8 million in cash dividends received on FHLB stock, compared to \$3.7 million received during the three months ended September 30, 2007. At September 30, 2008 and 2007, we owned \$373.4 million and \$331.1 million of FHLB stock, respectively. We also recorded \$2.1 million and \$0.9 million in subsidiary income for the three months ended September 30, 2008 and 2007, respectively. We recorded \$0.9 million and \$0.6 million of penalty fees during the three months ended September 30, 2008 and 2007, respectively. In addition, we recorded expense of \$1.1 million and an income of \$1.0 million related to adjustments to our estimates in calculating our secondary market reserve, for the three months ended September 30, 2008 and 2007, respectively.

***Nine months.*** During the nine months ended September 30, 2008, we recorded \$14.5 million in cash dividends received on FHLB stock, compared to the \$11.1 million received during the nine months ended September 30, 2007. We also recorded \$5.4 million and \$2.5 million in subsidiary income for the nine months ended September 30, 2008 and 2007, respectively. We recorded \$7.7 million and \$6.4 million in various fee and miscellaneous income during the nine months ended September 31, 2008 and 2007, respectively. In addition, we recorded income of \$0.5 million and an expense of \$4.4 million relating to adjustments to our estimates in calculating our secondary market reserve for the nine months ended September 30, 2008 and 2007, respectively.

**Table of Contents****Non-Interest Expense**

The following table sets forth the components of our non-interest expense, along with the allocation of expenses related to loan originations that are deferred pursuant to SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Lease* ( SFAS 91 ). As required by SFAS 91, loan fees and direct origination costs (principally compensation and benefits) are capitalized as an adjustment to the basis of the loans originated during the period and amortized to expense over the lives of the respective loans rather than immediately expensed. Other expenses associated with loan production, however, are not required or allowed to be capitalized and are, therefore, expensed when incurred.

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	(Dollars in thousands)			
Compensation and benefits	\$ 54,487	\$ 44,653	\$ 165,524	\$ 129,924
Commissions	26,298	18,136	86,401	52,959
Occupancy and equipment	19,492	17,622	59,816	51,446
Advertising	3,574	3,065	8,231	7,719
Federal insurance premium	1,566	1,257	4,911	3,078
Communications	1,974	1,579	6,218	4,559
Other taxes	(1,359)	(470)	(83)	(1,053)
Asset resolution	18,019	1,952	29,798	6,912
Other	24,764	8,706	36,690	26,929
Subtotal	148,815	96,500	397,506	282,473
Less: capitalized direct costs of loan closings, under SFAS 91	(29,651)	(23,240)	(95,438)	(65,581)
Non-interest expense	\$ 119,164	\$ 73,260	\$ 302,068	\$ 216,892
Efficiency ratio <sup>(1)</sup>	105.2%	132.7%	79.0%	85.2%

(1) Operating and administrative expenses divided by the sum of net interest income and non-interest income.

*Three Months.* Non-interest expense, before the capitalization of loan origination costs, increased \$52.3 million to \$148.8 million during the three months ended September 30, 2008, from \$96.5 million for the comparable 2007 period. The following are the major changes affecting non-interest expense as reflected in the consolidated statements of operations:

The banking operation conducted business from 15 more facilities at September 30, 2008 than at September 30, 2007.

We conducted business from 40 fewer home lending centers at September 30, 2008 than at September 30, 2007.

The home lending operation originated \$6.7 billion in residential mortgage loans during the 2008 quarter versus \$6.6 billion in the comparable 2007 quarter.

We employed 3,291 salaried employees at September 30, 2008 versus 2,939 salaried employees at September 30, 2007.

We employed 224 full-time national account executives at September 30, 2008 versus 198 at September 30, 2007.

We employed 512 full-time retail loan originators at September 30, 2008 versus 654 at September 30, 2007.

Compensation and benefits expense increased \$9.8 million during the 2008 period from the comparable 2007 period to \$54.5 million, with the increase primarily attributable to regular salary increases for employees, additional staff and support personnel for the newly-opened banking centers, additional staff for collections and loss mitigation and additional underwriters and other support staff to manage the sizeable increase in FHA business.

The increase in commissions earned by the commissioned sales staff during the 2008 period over the comparable 2007 period was \$8.2 million. This change reflects the increase in loan production in our home lending centers of 46.5% for

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the third quarter of 2008 as compared to the same period in 2007. Commission percentages are typically higher for the retail loan originators than the wholesale account executives.

Asset resolution expense consists of foreclosure costs, loss provisions and gains and losses on the sale of real estate owned (REO) properties that we have obtained through foreclosure proceedings. Asset resolution expense for the comparable period increased \$16.1 million to \$18.0 million. Because of the climate of the housing market, provision for REO loss was increased from \$0.9 million to \$13.2 million, an increase of \$12.3 million net of any gain on REO and recovery of related debt.

The 184.5% increase in other expense during the 2008 period from the comparable 2007 period is principally reflective of an increase in expected losses on commercial letters of credit of \$9.9 million and an increase in incurred losses under reinsurance contracts of \$4.7 million.

During the three months ended September 30, 2008, we capitalized direct loan origination costs of \$29.7 million, an increase of \$6.5 million from \$23.2 million for the comparable 2007 period. This 28.0% increase is a result of an \$8.2 million, or 45.3%, increase in commission expense and an increase in the direct loan origination costs during the 2008 period versus the 2007 period.

*Nine months.* Non-interest expense, before capitalization of direct loan origination costs, increased \$115.0 million to \$397.5 million during the nine months ended September 30, 2008, from \$282.5 million for the comparable 2007 period.

Compensation and benefits expense increased \$35.6 million during the 2008 period from the comparable 2007 period to \$165.5 million and was primarily attributable to regular salary increases for employees and additional staff and support personnel for the newly-opened banking centers, additional staff for collections and loss mitigation and additional underwriters and other support staff to manage the sizeable increase in FHA business.

Commissions earned by the commissioned sales staff for the comparable period increased \$33.4 million. This increase reflects in part the 65.0% increase in the home lending portion of loan production, for which commissions are higher.

Asset resolution expense for the comparable period increased \$22.9 million to \$29.8 million. Because of the climate of the housing market, provision for REO loss was increased to \$19.4 million from \$3.4 million, an increase of \$16.0 million, offset in part by gain on REO and recovery of related debt. Legal services related to foreclosure costs increased to \$15.5 million from \$9.9 million.

The 36.2% increase in other expense during the 2008 period from the comparable 2007 period is principally reflective of an increase in expected losses on commercial letters of credit of \$11.0 million and an increase in incurred losses under reinsurance contracts of \$4.7 million.

During the nine months ended September 30, 2008, we capitalized direct loan origination costs of \$95.4 million, an increase of \$29.8 million from \$65.6 million for the comparable 2007 period. This 45.5% increase is a result of the increase in commission expense and other direct loan origination costs resulting from the increase in loan originations.

### **Benefit for Federal Income Taxes**

For the three months ended September 30, 2008, our benefit for federal income taxes as a percentage of pretax loss was (35.0)% compared to (33.6)% in 2007. For the nine months ended September 30, 2008, our benefit for federal income taxes as a percentage of pretax loss was (34.8)% compared to (26.1)% in 2007. For each period, the benefit for federal income taxes varies from statutory rates primarily because of certain non-deductible corporate expenses.

### **Analysis of Items on the Consolidated Statement of Financial Condition**

#### **Assets**

***Securities Classified as Trading.*** Securities classified as trading are comprised of residual interests from our private-label securitizations. The residual interests in these securitizations were \$23.1 million at September 30, 2008 versus \$13.7 million at December 31, 2007. The increase in securities classified as trading was a result of our election, in conjunction with the fair value option under SFAS 159, to reclassify (to this account) the residual interests that were previously classified as securities available for sale. Changes to fair value are recorded in the consolidated statement of operations.

***Securities Classified as Available for Sale.*** Securities classified as available for sale, which are comprised of mortgage-backed securities, collateralized mortgage obligations and, prior to January 1, 2008, residual interests from

securitizations of mortgage loan products decreased from \$1.3 billion at December 31, 2007, to \$1.0 billion at September 30, 2008. See Note 5 of the Notes to the Consolidated Financial Statements, in Item 1. Financial Statements herein.

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**Mortgage-backed Securities Held to Maturity.** Mortgage-backed securities held to maturity decreased from \$1.3 billion at December 31, 2007 to zero at September 30, 2008. The decrease was attributable to management's decision to reclassify these securities to the available for sale category as of March 31, 2008. The reclassification was required because management no longer intends to hold these securities to maturity. A significant portion of these securities were sold subsequent to the reclassification. At December 31, 2007, \$107.6 million of the mortgage-backed securities were pledged as collateral under security repurchase agreements.

**Other Investments.** Our investment portfolio increased from \$26.8 million at December 31, 2007, to \$31.8 million at September 30, 2008. Investment securities consist of mutual funds held as contractually required collateral, regulatory required collateral, and investments made by our non-bank subsidiaries.

**Loans Available for Sale.** We sell a majority of the mortgage loans we produce into the secondary market on a whole loan basis or by securitizing the loans into mortgage-backed securities. At September 30, 2008, we held loans available for sale of \$2.0 billion, which was a decrease of \$1.5 billion from \$3.5 billion held at December 31, 2007. The decrease was attributed to management's decision to reclassify approximately \$1.6 billion of mortgage loans, consumer loans and second mortgage loans to loans held for investment during the second and third quarter of 2008, net of mark downs taken upon transfers, because management no longer had the intent to sell these loans.

**Loans Held for Investment.** Loans held for investment at September 30, 2008 increased \$880.5 million from December 31, 2007. The increase was principally attributable to reclassifications of approximately \$1.6 billion of mortgage loans, second mortgage loans and consumer loans from loans available for sale. This increase was partially offset by principal reductions on loans held for investment from normal payments.

**Allowance for Loan Losses.** The allowance for loan losses represents management's estimate of probable losses in our loans held for investment portfolio as of the date of the consolidated financial statements. The allowance provides for probable losses that have been identified with specific customer relationships and for probable losses believed to be inherent in the loan portfolio but that have not been specifically identified.

The allowance for loan losses increased to \$224.0 million at September 30, 2008 from \$104.0 million at December 31, 2007, respectively. Our non-performing loans (i.e., loans that are past due 90 days or more) increased to \$413.7 million from \$197.1 million at September 30, 2008 and December 31, 2007, respectively. The allowance for loan losses as a percentage of investment loans increased to 2.45% at September 30, 2008 from 1.28% at December 31, 2007. The increase in the allowance for loan losses at September 30, 2008 reflects management's assessment of the effect of increased levels of charge-offs as well as increases in classified and non-performing loans. The allowance for loan losses as a percentage of non-performing loans increased to 54.1% from 52.8% at September 30, 2008 and December 31, 2007, respectively. The delinquency rate increased in the first nine months of the year to 6.92% as of September 30, 2008, up from 3.49% as of December 31, 2007.

The allowance for loan losses is considered adequate based upon management's assessment of relevant factors, including the types and amounts of delinquent and non-performing loans, historical and current loss experience on such types of loans, and the current economic environment. The following table provides the amount of delinquent loans at the dates listed. At September 30, 2008, 76.3% of all delinquent loans are loans in which we have a first lien position on residential real estate.

**Delinquent Loans**

	September 30, 2008	% of Loans	December 31, 2007	% of Loans	September 30, 2007	% of Loans
Days Delinquent			(Dollars in thousands)			
30	\$ 107,313	1.18%	\$ 59,811	0.74%	\$ 73,382	1.05%
60	110,943	1.21	70,450	0.87	44,481	0.63
90	413,717	4.53	197,149	2.42	127,506	1.81
Total	\$ 631,973	6.92%	\$ 327,410	4.03%	\$ 245,369	3.49%



Investment loans	\$ 9,134,884	\$ 8,134,397	\$ 7,034,732
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We currently calculate our delinquent loans using a method required by the Office of Thrift Supervision when we prepare regulatory reports that we submit to the OTS each quarter. This method, also called the OTS Method, treats a loan as delinquent if no payment is received after the first day of the month following the month of the missed payment. Other companies with mortgage banking operations similar to ours usually use the Mortgage Bankers Association Method ( MBA Method ) which considers a loan to be delinquent if payment is not received by the end of the month of the missed payment. The key difference between the two methods is that a loan considered delinquent under the MBA Method would not be considered delinquent under the OTS Method for another 30 days. Under the MBA Method of calculating delinquent loans,

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30 day delinquencies equaled \$215.9 million, 60 day delinquencies equaled \$117.5 million and 90 day delinquencies equaled \$503.4 million at September 30, 2008. Total delinquent loans under the MBA Method total \$836.9 million or 9.16% of loans held for investment at September 30, 2008, as compared to, \$478.3 million, or 5.88% of total loans held for investment at December 31, 2007.

The following table shows the activity in the allowance for loan losses during the indicated periods (dollars in thousands):

**Activity Within the Allowance For Loan Losses**

	<b>Nine Months Ended</b>		<b>Year Ended</b>
	<b>September</b>	<b>September</b>	<b>December</b>
	<b>30,</b>	<b>30,</b>	<b>31,</b>
	<b>2008</b>	<b>2007</b>	<b>2007</b>
Beginning balance	\$ 104,000	\$ 45,779	\$ 45,779
Provision for loan losses	167,708	49,941	88,297
Charge-offs			
Mortgage loans	(29,384)	(12,453)	(17,468)
Consumer loans	(5,127)	(6,792)	(9,827)
Commercial loans	(13,124)	(379)	(4,765)
Construction loans	(169)		
Other	(1,442)	(1,122)	(1,599)
Total charge-offs	(49,246)	(20,746)	(33,659)
Recoveries			
Mortgage loans	330	536	687
Consumer loans	806	1,959	2,258
Commercial loans	7	1	174
Construction loans			
Other	395	330	464
Total recoveries	1,538	2,826	3,583
Charge-offs, net of recoveries	(47,708)	(17,920)	(30,076)
Ending balance	\$ 224,000	\$ 77,800	\$ 104,000
Net charge-off ratio	0.71%	0.34%	0.38%

**Accrued Interest Receivable.** Accrued interest receivable decreased from \$57.9 million at December 31, 2007, to \$53.3 million at September 30, 2008, due to the timing of payments. We typically collect interest in the month following the month in which it is earned.

**Repurchased Assets.** We sell a majority of the mortgage loans we produce into the secondary market on a whole loan basis or by securitizing the loans into mortgage-backed securities. When we sell or securitize mortgage loans, we make customary representations and warranties to the purchasers about various characteristics of each loan, such as the manner of origination, the nature and extent of underwriting standards applied and the types of documentation being provided. When a loan that we have sold or securitized fails to perform according to its contractual terms, the purchaser will typically review the loan file to determine whether defects in the origination process occurred and if such defects constitute a violation of our representations and warranties. If there are no such defects, we have no liability to the purchaser for losses it may incur on such loan. If a defect is identified, we may be required to either

repurchase the loan or indemnify the purchaser for losses it sustains on the loan. Loans that are repurchased and that are performing according to their terms are included within our loans held for investment portfolio. Repurchased assets are loans that we have reacquired because of representation and warranties issues related to loan sales or securitizations and that are non-performing at the time of repurchase. To the extent we later foreclose on the loan, the underlying property is transferred to repossessed assets for disposal. During the three months ended September 30, 2008 and 2007, we repurchased \$16.0 million and \$13.7 million in unpaid principal balance of non-performing loans, respectively. The estimated fair value of the remaining repurchased assets totaled \$15.4 million at September 30, 2008 and \$8.1 million at December 31, 2007, and is included within other assets in our consolidated statements of financial condition.

***Premises and Equipment.*** Premises and equipment, net of accumulated depreciation, totaled \$246.3 million at September 30, 2008, an increase of \$8.6 million, or 3.6%, from \$237.7 million at December 31, 2007. The increase reflects the continued expansion of our retail banking center network.

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**Mortgage Servicing Rights.** At September 30, 2008, MSR's included residential MSR's at fair value amounting to \$722.2 million and consumer MSR's at amortized cost amounting to \$10.0 million. At December 31, 2007, all MSR's were accounted for on an amortized cost basis and amounted to \$414.0 million of which \$402.2 million were residential. As of January 1, 2008, we elected the fair value method for residential MSR's and recorded a cumulative effect adjustment to retained earnings of \$43.7 million, which increased the balance of our residential MSR's. During the nine month period ended September 30, 2008, we recorded additions to our residential MSR's of \$291.9 million due to loan sales or securitizations. Additionally, we recorded a fair value adjustment to decrease the fair value of the residential MSR's by \$15.7 million. The adjustment included approximately \$42.8 million in the reduction of fair value due to payoffs offset by \$27.1 million of market driven charges, primarily an increase in mortgage loan rates that led to an expected decrease in prepayment speeds. The increase in the capitalized value of the MSR's from December 31, 2007 to September 30, 2008 includes the effect of the change in accounting from amortized cost to fair value. See Note 9 in Part I, Item 1 Financial Statements, herein.

The principal balance of the loans underlying our total MSR's was \$51.8 billion at September 30, 2008 versus \$32.5 billion at December 31, 2007, reflecting our 2008 loan origination activity without any bulk MSR sales during the 2008 period.

**Other Assets.** Other assets increased \$167.3 million, or 110.7%, to \$318.4 million at September 30, 2008, from \$151.1 million at December 31, 2007. The majority of this change was attributable to a net increase of \$11.5 million in accounts relating to derivative activities utilized to hedge our MSR portfolio, a \$18.8 million increase in mortgage banking derivatives, an increase of \$64.1 million relating to the estimated fair value of repurchased assets and an increase in deferred federal and state income tax benefit of \$60.8 million and \$14.7 million, respectively.

**Liabilities**

**Deposit Accounts.** Deposit accounts decreased \$0.8 billion to \$7.4 billion at September 30, 2008, from \$8.2 billion at December 31, 2007. Although our total deposits decreased, the majority of the decrease came from a reduction in more expensive certificates of deposit, municipal deposits and national accounts. This reduction was executed as part of our strategy to shrink the size of our balance sheet and increase our net interest margin. The composition of our deposits was as follows:

**Deposit Portfolio**  
(Dollars in thousands)

	September 30, 2008			December 31, 2007		
	Balance	Weighted Average Rate	Percent of Balance	Balance	Weighted Average Rate	Percent of Balance
Demand accounts	\$ 419,109	0.63%	5.65%	\$ 436,239	1.60%	5.30%
Savings accounts	410,069	2.50%	5.53	237,762	2.90%	2.89
MMDA	520,664	2.68%	7.02	531,587	3.86%	6.45
Certificates of deposit <sup>(1)</sup>	3,418,840	4.05%	46.06	3,870,828	4.99%	46.99
Total Retail Deposits	4,768,682	3.47%	64.26	5,076,416	4.48%	61.63
Municipal deposits <sup>(2)</sup>	1,213,150	3.01%	16.35	1,545,395	5.04%	18.76
National accounts	970,257	4.78%	13.07	1,141,549	4.64%	13.86
Company controlled deposits <sup>(3)</sup>	468,715	0.00%	6.32	473,384	0.00%	5.75
Total Deposits	\$ 7,420,804	3.35%	100.0%	\$ 8,236,744	4.35%	100.0%

(1)

The aggregate amount of certificates of deposit with a minimum denomination of \$100,000 was approximately \$2.1 billion and \$2.8 billion at September 30, 2008 and December 31, 2007, respectively.

- (2) Municipal deposits includes funds from municipalities and public schools.
- (3) These accounts represent the portion of the investor custodial accounts and escrows controlled by Flagstar that have been placed on deposit with the Bank.

The municipal deposit channel was \$1.2 billion at September 30, 2008 and \$1.5 billion at December 31, 2007. These deposits have been garnered from local government units within our retail market area.

Our national accounts division garnered funds through the use of investment banking firms and deposit brokers. National deposit accounts decreased \$0.1 billion to \$1.0 billion at September 30, 2008, from \$1.1 billion at December 31, 2007. At September 30, 2008, the national deposit accounts had a weighted maturity of 17.5 months.

The Company controlled accounts remained constant at \$0.5 billion for September 30, 2008 and December 31, 2007.

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**FHLB Advances.** Our borrowings from the FHLB, known as FHLB advances, may include floating rate daily adjustable advances, fixed rate convertible (i.e., putable ) advances, and fixed rate term (i.e., bullet ) advances. The following is a breakdown of the advances outstanding (dollars in thousands):

	September 30, 2008		December 31, 2007	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate
Fixed rate putable advances	\$ 2,150,000	4.02%	\$ 1,900,000	4.13%
Short-term fixed rate term advances	638,000	3.73%	1,851,000	4.07%
Long-term fixed rate term advances	2,650,000	4.57%	2,550,000	4.69%
Total	\$ 5,438,000	4.26%	\$ 6,301,000	4.34%

FHLB advances decreased \$0.9 billion to \$5.4 billion at September 30, 2008, from \$6.3 billion at December 31, 2007, as we reduced our asset size from \$15.8 billion at December 31, 2007 to \$14.2 billion at September 30, 2008. We rely upon such advances as a source of funding for the origination or purchase of loans for sale in the secondary market and for providing duration specific medium-term financing. The outstanding balance of FHLB advances fluctuates from time to time depending upon our current inventory of loans available for sale that we fund with the advances and upon the availability of lower cost funding from our retail deposit base, the escrow accounts we hold, or alternative funding sources such as security repurchase agreements. Our approved line with the FHLB was \$7.0 billion at September 30, 2008.

**Security Repurchase Agreements.** Securities sold under agreements to repurchase are generally accounted for as collateralized financing transactions and are recorded at the amounts at which the securities were sold plus accrued interest. Securities are pledged as collateral under these financing arrangements. The fair value of collateral provided to a party is continually monitored and additional collateral is provided by or returned to us, as appropriate. At both September 30, 2008 and December 31, 2007, we had security repurchase agreements amounting to \$108.0 million.

**Long Term Debt.** Our long-term debt principally consists of junior subordinated notes related to trust preferred securities issued by the Company's special purpose trust subsidiaries. The notes mature 30 years from issuance, are callable after five years and pay interest quarterly. At both September 30, 2008 and December 31, 2007, we had \$248.7 million of long-term debt.

**Accrued Interest Payable.** Our accrued interest payable decreased \$19.9 million from December 31, 2007 to \$27.2 million at September 30, 2008. The decrease was principally due to the decrease in interest rates during 2008 on our interest-bearing liabilities.

**Secondary Market Reserve.** We sell most of the residential mortgage loans that we originate into the secondary mortgage market. When we sell mortgage loans, we make customary representations and warranties to the purchasers about various characteristics of each loan, such as the manner of origination, the nature and extent of underwriting standards applied and the types of documentation being provided. Typically these representations and warranties are in place for the life of the loan. If a defect in the origination process is identified, we may be required to either repurchase the loan or indemnify the purchaser for losses it sustains on the loan. If there are no such defects, we have no liability to the purchaser for losses it may incur on such loan. We maintain a secondary market reserve to account for the expected losses related to loans we may be required to repurchase (or the indemnity payments we may have to make to purchasers). The secondary market reserve takes into account both our estimate of expected losses on loans sold during the current accounting period, as well as adjustments to our previous estimates of expected losses on loans sold. In each case these estimates are based on our most recent data regarding loan repurchases, and actual credit losses on repurchased loans, among other factors. Increases to the secondary market reserve for current loan sales reduce our net gain on loan sales. Adjustments to our previous estimates are recorded as an increase or decrease in our other fees and charges.

The secondary market reserve increased \$1.0 million to \$28.6 million at September 30, 2008, from \$27.6 million at December 31, 2007. This increase is attributable to the Company's expected losses and historical experience of repurchases and claims.

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The following table provides a reconciliation of the secondary market reserve within the periods shown (in thousands):

**Secondary Market Reserve**

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Balance, beginning of period	\$ 28,000	\$ 27,300	\$ 27,600	\$ 24,200
Provision				
Charged to gain on sale for current loan sales	2,376	2,697	8,183	7,611
Charged to other fees and charges for changes in estimates	1,087	(974)	(474)	4,046
Total	3,463	1,723	7,709	11,657
Charge-offs, net	(2,863)	(1,523)	(6,709)	(8,357)
Balance, end of period	\$ 28,600	\$ 27,500	\$ 28,600	\$ 27,500

Reserve levels are a function of expected losses based on actual pending and expected claims, historical experience and loan volume. While the ultimate amount of repurchases and claims is uncertain, management believes that the amount of reserves at September 30, 2008 is adequate.

**Other Liabilities.** Other liabilities increase \$82.6 million, or 64.0%, to \$211.6 million at September 30, 2008 from \$129.0 million at December 31, 2007. The majority of the increase was attributable to an increase of \$12.9 million in escrow accounts, a \$21.0 million increase in undisbursed payments to others, a \$6.9 million increase in accrued payroll, an increase of \$11.0 million in reserves relating to our commercial letters of credit and a \$4.1 million increase in our premium deficiency reserve on our wholly-owned reinsurance company.

**Liquidity and Capital**

**Liquidity.** Liquidity refers to the ability or the financial flexibility to manage future cash flows in order to meet the needs of depositors and borrowers and to fund operations on a timely and cost-effective basis. Our primary sources of funds are deposits, loan repayments and sales, advances from the FHLB, security repurchase agreements, cash generated from operations, custodial accounts and customer escrow accounts. From time to time, we also draw upon our line of credit at the Federal Reserve discount window. While we believe that these sources of funds will continue to be adequate to meet our liquidity needs for the foreseeable future, there is currently illiquidity in the non-agency secondary mortgage market and reduced investor demand for mortgage-backed securities and loans in that market. Under these conditions, we use our liquidity, as well as our capital capacity, to hold increased levels of both securities and loans. While our liquidity and capital positions are currently sufficient, our capacity to retain loans and securities on our consolidated statement of financial condition is not unlimited and we have revised our lending guidelines as a result of a prolonged period of secondary market illiquidity to primarily originate loans that could readily be sold to Fannie Mae and Freddie Mac or be federally insured by Ginnie Mae.

Retail deposits decreased to \$4.8 billion at September 30, 2008, as compared to \$5.1 billion at December 31, 2007. This reduction was executed as part of our strategy to shrink the size of our balance sheet.

Mortgage loans sold during the nine months ended September 30, 2008 totaled \$22.1 billion, an increase of \$5.1 billion from the \$17.0 billion sold during the same period in 2007. We attribute this increase to the interest rate environment, resulting in an increase in demand for fixed-rate mortgage loans, to an increase in our market share which we believe results in part from the reduced number of potential competitors and to our decision to sell substantially all of the residential mortgage loans that we originate during 2008. Among other things, our increase in market share was driven by a significant increase in FHA volume, as we are now the seventh largest FHA lender in



the United States. We sold 97.7% and 88.3% of our mortgage loan originations during the nine month periods ended September 30, 2008 and 2007, respectively.

We use FHLB advances and, to a lesser extent, security repurchase agreements to fund our daily operational liquidity needs and to assist in funding loan originations. We will continue to use these sources of funds as needed to supplement funds from deposits, loan and MSR sales, custodial accounts and escrow accounts. We currently have an authorized line of credit equal to \$7.0 billion, which we may draw upon subject to providing a sufficient amount of loans as collateral. At September 30, 2008, we had borrowed \$5.4 billion. Such advances are usually repaid with the proceeds from the sale of mortgage loans or from alternative sources of financing.

At September 30, 2008, we had arrangements to enter into security repurchase agreements, which is a form of collateralized short-term borrowing, with multiple financial institutions (each of which is a primary dealer for Federal Reserve

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purposes). Because we borrow money under these agreements based on the fair value of our mortgage-backed securities, and because changes in interest rates can negatively impact the valuation of mortgage-backed securities, our borrowing ability under these agreements could be limited and lenders could initiate margin calls (i.e., require us to provide additional collateral) in the event interest rates change or the value of our mortgage-backed securities declines for other reasons. At September 30, 2008, our security repurchase agreements totaled \$108.0 million.

At September 30, 2008, we had arrangements with the Federal Reserve Bank of Chicago (FRB) to borrow as needed from its discount window. During the third quarter of 2008, the maximum outstanding at any one time to the FRB was \$300 million and the \$832 million line was undrawn as of September 30, 2008. We accessed this line from time to time throughout the quarter in order to reduce our overall cost of funds. The amount we are allowed to borrow is based on the lendable value of the collateral that we provide. At September 30, 2008, the lendable value of the collateral we pledged to the FRB totaled \$1.1 billion of which no borrowings were outstanding.

At September 30, 2008, we had outstanding rate-lock commitments to lend \$3.2 billion in mortgage loans, along with outstanding commitments to make other types of loans totaling \$2.2 million. As such commitments may expire without being drawn upon, they do not necessarily represent future cash commitments. Also, at September 30, 2008, we had outstanding commitments to sell \$3.1 billion of mortgage loans. We expect that our lending commitment will be funded within 90 days. Total commercial and consumer unused lines of credit totaled \$1.5 billion at September 30, 2008, including \$853.7 million of unused warehouse lines of credit to various mortgage companies, of which we had advanced \$344.7 million at September 30, 2008. There was an additional \$11.5 million in undrawn lines of credit contained within consumer loans.

*Regulatory Capital Adequacy.* At September 30, 2008, the Bank exceeded all applicable bank regulatory minimum capital requirements and was considered well capitalized for both Tier 1 capital and total risk-based capital purposes. The Company is not subject to regulatory capital requirements.

The Bank's regulatory capital includes proceeds from trust preferred securities that were issued in nine separate private offerings to the capital markets and as to which \$247.4 million of such securities were outstanding at September 30, 2008.

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

Our exposure to interest rate risk arises from three distinctly managed mechanisms home lending, mortgage servicing, and structural balance sheet maturity or repricing mismatches.

In our home lending operations, we are exposed to market risk in the form of interest rate risk from the time we commit to an interest rate on a mortgage loan application through the time we sell, or commit to sell, the mortgage loan. On a daily basis, we analyze various economic and market factors to project the amount of mortgage loans we expect to sell for delivery at a future date. The actual amount of loans sold will be a percentage of the amount of mortgage loans on which we have issued binding commitments (and thereby locked in the interest rate) but have not yet closed ( pipeline loans ) to actual closings. If interest rates change in an unanticipated fashion, the actual percentage of pipeline loans that close may differ from the projected percentage. A mismatch of our commitments to fund mortgage loans and our commitments to sell mortgage loans may have an adverse effect on the results of operations in any such period. For instance, a sudden increase in interest rates may cause a higher percentage of pipeline loans to close than we projected, and thereby exceed our commitments to sell that pipeline of loans. As a result, we could incur losses upon sale of these additional loans to the extent the market rate of interest is higher than the mortgage interest rate committed to by us on pipeline loans we had initially anticipated to close. To the extent that the hedging strategies utilized by us are not successful, our profitability may be adversely affected.

We also service residential mortgages for various external parties. We receive a service fee based on the unpaid balances of servicing rights as well as ancillary income (late fees, float on payments, etc.) as compensation for performing the servicing function. An increase in mortgage prepayments, as is often associated with declining interest rates, can lead to reduced values on capitalized mortgage servicing rights and ultimately reduced loan servicing revenues. In the first quarter of 2008, we began to specifically hedge the market risk associated with mortgage servicing rights using a portfolio of Treasury note futures and options. To the extent that the hedging strategies are not effective, our profitability associated with the mortgage servicing activity may be adversely affected.

In addition to the home lending and mortgage servicing operations, our banking operations may be exposed to market risk due to differences in the timing of the maturity or repricing of assets versus liabilities, as well as the potential shift in the yield curve. This risk is evaluated and managed on a company-wide basis using a net portfolio value (NPV) analysis framework. The NPV analysis is intended to estimate the net sensitivity of the fair value of the assets and liabilities to sudden and significant changes in the levels of interest rates.

### **Item 4. Controls and Procedures**

**(a) Disclosure Controls and Procedures.** A review and evaluation was performed by our principal executive and financial officers regarding the effectiveness of our disclosure controls and procedures as of September 30, 2008 pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended. Based on that review and evaluation, the principal executive and financial officers have concluded that our current disclosure controls and procedures, as designed and implemented, are operating effectively.

**(b) Changes in Internal Controls.** During the quarter ended September 30, 2008, there has been no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) of the Securities Exchange Act of 1934, as amended, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

Other than as set forth below, there have been no material changes to the risk factors previously disclosed in response to Item 1A to Part I of our 2007 Annual Report on Form 10-K (the "2007 Form 10-K"). The first two risk factors below, previously included in the Form 10-Q for the quarter ended March 31, 2008, are in addition to the risk factors included in the 2007 Form 10-K, and the last risk factor below replaces the risk factor in the 2007 Form 10-K labeled "Our ability to borrow funds and raise capital could be limited, which could adversely affect our earnings."

**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 rates.**

We invest in MSRs to support our mortgage banking strategies and to deploy capital at acceptable returns. The value of these assets and the income they provide tend to be counter-cyclical to the changes in production volumes and gain on sale of loans that result from changes in interest rates. We also enter into derivatives to hedge our MSRs to offset losses in fair value resulting from the actual or anticipated increase in prepayments in declining interest rate environments. The primary risk associated with MSRs is that they will lose a substantial portion of their value as a result of higher than anticipated prepayments occasioned by declining interest rates. Conversely, these assets generally increase in value in a rising interest rate environment to the extent that prepayments are slower than anticipated. Our hedging strategies are highly susceptible to prepayment risk, basis risk, market volatility and changes in the shape of the yield curve, among other factors. In addition, our hedging strategies rely on assumptions and projections regarding our assets and general market factors. If these assumptions and projections prove to be incorrect or our hedging strategies do not adequately mitigate the impact of changes in interest rates or prepayment speeds, we may incur losses that would adversely impact our earnings.

**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.**

We face the risk that one or more of our institutional counterparties may fail to fulfill their contractual obligations to us. Our primary exposures to institutional counterparty risk are with third-party providers of credit enhancement on the mortgage assets that we hold in our investment portfolio, including mortgage insurers and financial guarantors, issuers of securities held on our balance sheet, and derivatives counterparties.

The challenging mortgage and credit market conditions have adversely affected, and will likely continue to adversely affect, the liquidity and financial condition of a number of our institutional counterparties, particularly those whose businesses are concentrated in the mortgage industry. One or more of these institutions may default in its obligations to us for a number of reasons, such as changes in financial condition that affect their credit ratings, a reduction in liquidity, operational failures or insolvency. Several of our institutional counterparties have experienced ratings downgrades and liquidity constraints. These and other key institutional counterparties may become subject to serious liquidity problems that, either temporarily or permanently, negatively affect the viability of their business plans or reduce their access to funding sources. The financial difficulties that a number of our institutional counterparties are currently experiencing may negatively affect the ability of these counterparties to meet their obligations to us and the amount or quality of the products or services they provide to us. A default by a counterparty with significant obligations to us could result in significant financial losses to us and could materially adversely affect our ability to conduct our operations, which would adversely affect our earnings, liquidity, capital position and financial condition.

**Our ability to borrow funds, maintain or increase deposits or raise capital could be limited, which could adversely affect our liquidity and earnings.**

Our access to external sources of financing, including deposits, as well as the cost of that financing, is dependent on various factors. Many of these factors depend upon market perceptions of events that are beyond our control, such as the failure of other banks or financial institutions. Other factors are dependent upon our results of operations including, but not limited to material changes in operating margins; earnings trends and volatility; funding and

liquidity management practices; financial leverage on an absolute basis or relative to peers; the composition of the statement of financial condition and/or capital structure; geographic and business diversification; and our market share and competitive position in the business segments in which we operate. The material deterioration in any one or a combination of these factors could result in a downgrade of our credit or servicer ratings or a decline in our perception within the marketplace and could result in a limited ability to borrow funds, maintain or increase deposits (including custodial deposits for our agency servicing portfolio) or to raise capital.

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Our ability to make mortgage loans depends largely on our ability to secure funds on terms acceptable to us. Our primary sources of funds to meet our financing needs include loan sales and securitizations, deposits, which include custodial amounts from our agency servicing portfolio, borrowings from the FHLB, borrowings from investment and commercial banks through repurchase agreements, and capital-raising activities. If we are unable to maintain any of these financing arrangements or arrange for new financing on terms acceptable to us, or if we default on any of the covenants imposed upon us by our borrowing facilities, then we may have to reduce the number of loans we are able to originate for sale in the secondary market or for our own investment. A sudden and significant reduction in loan originations that occurs as a result could adversely impact our earnings. There is no guarantee that we will be able to renew or maintain our financing arrangements or that we will be able to adequately access capital markets when or if a need for additional capital arises.

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

None.

**Issuer Purchases of Equity Securities**

The Company made no purchases of its equity securities during the quarter ended September 30, 2008.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

At the Company's Special Meeting of Stockholders on August 12, 2008, the Company's stockholders approved the automatic conversion of 47,982 shares of the Company's mandatory convertible non-cumulative perpetual preferred stock, series A, into approximately 11,289,878 shares of common stock. The votes for, votes against and abstentions (there were no broker non-votes) were as follows:

Votes for	39,167,855
Votes against	424,591
Abstentions	100,290

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

- 11 Computation of Net Earnings per Share
- 31.1 Section 302 Certification of Chief Executive Officer
- 31.2 Section 302 Certification of Chief Financial Officer
- 32.1 Section 906 Certification, as furnished by the Chief Executive Officer
- 32.2 Section 906 Certification, as furnished by the Chief Financial Officer

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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.

FLAGSTAR BANCORP, INC.

Date: November 10, 2008

/s/ Mark T. Hammond  
Mark T. Hammond  
President and Chief Executive Officer  
(Duly Authorized Officer)

/s/ Paul D. Borja  
Paul D. Borja  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer)

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**EXHIBIT INDEX**

**Ex. No.      Description**

11	Statement regarding Computation of Net Earnings per Share
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1	Section 906 Certification, as furnished by the Chief Executive Officer
32.2	Section 906 Certification, as furnished by the Chief Financial Officer

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