FLAGSTAR BANCORP INC
Form 10-K
March 15, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009

OR

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

Commission file number: **001-16577**

(Exact name of registrant as specified in its charter)

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

Registrant s telephone number, including area code: **(248) 312-2000**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No þ

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

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

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

The estimated aggregate market value of the voting common stock held by non-affiliates of the registrant, computed by reference to the closing sale price ($0.68 per share) as reported on the New York Stock Exchange on June 30, 2009, was approximately $45.0 million. The registrant does not have any non-voting common equity shares.

As of March 8, 2010, 892,624,051 shares of the registrant s Common Stock, $0.01 par value, were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s Proxy Statement relating to its 2010 Annual Meeting of Stockholders have been incorporated into Part III of this Report on Form 10-K.

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Consent of Baker Tilly Virchow Krause, LLP
Section 302 Certification of Chief Executive Officer
Section 302 Certification of Chief Financial Officer

Section 906 Certification of Chief Executive Officer
Section 906 Certification of Chief Financial Officer
Certification of Principal Executive Officer(Section 111 (b)(4) of EESA)
Certification of Principal Financial Officer (Section 111 (b)(4) of EESA)

Cautions Regarding Forward-Looking Statements

This report contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of Flagstar Bancorp, Inc. (Flagstar or the Company) and these statements are subject to risk and uncertainty. Forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, include those using words or phrases such as believes, expects, anticipates, plans, trend, objective, continue, remain, pattern or similar expressions or future or conditional verbs such as would, should, could, might, can, may or similar expressions. There are a number of important factors that co cause our 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 this Form 10-K. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

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PART I

ITEM 1. BUSINESS

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

General

We are a Michigan-based savings and loan holding company founded in 1993. Our business is primarily conducted through our principal subsidiary, Flagstar Bank, FSB (the Bank), a federally chartered stock savings bank. At December 31, 2009, our total assets were $14.0 billion, making us the largest publicly held savings bank in the Midwest and one of the top 15 largest savings banks in the United States. We are considered a controlled company for New York Stock Exchange (NYSE) purposes because MP Thrift Investments, L.P. (MP Thrift) held approximately 80% of our voting common stock as of December 31, 2009 and approximately 89.5% as of January 31, 2010.

As a savings and loan holding company, we are subject to regulation, examination and supervision by the Office of Thrift Supervision (OTS) of the United States Department of the Treasury (Treasury). The Bank is a member of the Federal Home Loan Bank of Indianapolis (FHLBI) and is subject to regulation, examination and supervision by the OTS and the Federal Deposit Insurance Corporation (FDIC). The Bank s deposits are insured by the FDIC through the Deposit Insurance Fund (DIF).

We operate 165 banking centers (of which 30 are located in retail stores), including 114 located in Michigan, 24 located in Indiana and 27 located in Georgia. Through our banking centers, we gather deposits and offer a line of consumer and commercial financial products and services to individuals and to small and middle market businesses. We also gather deposits on a nationwide basis through our website, FlagstarDirect.com, and provide deposit and cash management services to governmental units on a relationship basis throughout our markets. We leverage our banking centers and internet banking to cross sell other products to existing customers and increase our customer base. At December 31, 2009, we had a total of $8.8 billion in deposits, including $5.4 billion in retail deposits, $0.6 billion in government funds, $2.0 billion in wholesale deposits and $0.8 million in company-controlled deposits.

We also operated 23 stand-alone home loan centers located in 14 states, which originate one-to-four family residential mortgage loans as part of our retail home lending business. These offices employ approximately 174 loan officers. We also originate retail loans through referrals from our 165 retail banking centers, consumer direct call center and our website, flagstar.com. Additionally, we have wholesale relationships with more that 4,700 mortgage brokers and nearly 1,200 correspondents, which are located in all 50 states and serviced by 162 account executives. The combination of our retail, broker and correspondent channels gives us broad access to customers across diverse geographies to originate, fulfill, sell and service our first mortgage loan products. Our servicing activities primarily include collecting cash for principal, interest and escrow payments from borrowers, and accounting for and remitting principal and interest payments to investors and escrow payments to third parties. With over $32.3 billion in mortgage originations in 2009, we are ranked by industry sources as the 12th largest mortgage originator in the nation with a 1.6% market share.

Our earnings include net interest income from our retail banking activities, fee-based income from services we provide our customers, and non-interest income from sales of residential mortgage loans to the secondary market, the servicing of loans for others, and the sale of servicing rights related to mortgage loans serviced for others.

Approximately 99.8% of our total loan production during 2009 represented mortgage loans that were collateralized by first or second mortgages on single-family residences and were eligible for sale through U.S. government-sponsored entities, or GSEs (a term generally used to refer collectively or singularly to Fannie Mae, Freddie Mac and Ginnie Mae).

At December 31, 2009, we had 3,411 full-time equivalent salaried employees of which 336 were account executives and loan officers.

Recent Developments

Supervisory Agreements

On January 27, 2010, we and the Bank each entered into a supervisory agreement with the OTS (respectively, the Bancorp Supervisory Agreement and the Bank Supervisory Agreement and, collectively, the Supervisory Agreements). We and the Bank have taken numerous steps to comply with, and intend to comply in the future with, all of the requirements of the Supervisory Agreements. We believe we developed our business plan to reflect the terms and requirements of the Supervisory Agreements and that the business plan thereby provides us with the flexibility to execute our strategy, including achieving our goals of asset growth, expanding our network of full service branches with a comprehensive range of product offerings, and originating consumer and commercial loans to small and middle market businesses. The Supervisory Agreements will remain in effect until terminated, modified, or suspended in writing by the OTS, and the failure to comply with the Supervisory Agreements could result in the initiation of further enforcement action by the OTS, including the imposition of further operating restrictions. See Regulatory and Supervision Supervisory agreements.

Capital Investment

In light of the operational challenges we have recently faced, our management team has developed and will continue to aggressively pursue a capital plan that is intended to bolster the Bank s capital ratios. Our capital plan contemplates taking steps that would strengthen our capital position in the short term and position us to build and diversify our business.

On December 31, 2009, we commenced a rights offering of up to 704,234,180 shares of our common stock. Pursuant to the rights offering each stockholder of record as of December 24, 2009 received 1.5023 non-transferable subscription rights for each share of common stock owned on the record date which entitled the holder to purchase one share of common stock at the subscription price of $0.71. On January 27, 2010, MP Thrift purchased 422,535,212 shares of common stock for approximately $300 million through the exercise of its rights received pursuant to the rights offering. During the rights offering, stockholders other than MP Thrift also exercised their rights and purchased 806,950 shares of common stock. In the aggregate, we issued 423,342,162 shares of common stock in the rights offering for approximately $300.6 million. The rights expired on February 8, 2010. Subsequent to the rights offering, MP Thrift held approximately 89.5% of our outstanding voting common stock.

On January 30, 2009, MP Thrift made its initial equity investment in us through its acquisition of 250,000 shares of Series B convertible participating voting preferred stock for $250 million. Upon receipt of stockholder approval, such preferred shares converted automatically at $0.80 per share into 312.5 million shares of common stock. Pursuant to an agreement between MP Thrift and us dated January 30, 2009, MP Thrift subsequently invested an additional $100 million through (a) a $50 million purchase of our convertible preferred stock in February 2009, and (b) a $50 million purchase of our trust preferred securities in June 2009. The convertible preferred shares were subsequently converted into 62.5 million shares of common stock. At December 31, 2009, MP Thrift owned 375 million shares of our common stock, representing approximately 80% of the voting common stock. The trust preferred securities are convertible into our common stock at the option of MP Thrift on April 1, 2010 at a conversion price of 90% of the volume weighted-average price per share of our common stock during the period from February 1, 2009 to April 1, 2010, subject to a price per share minimum of $0.80 and maximum of $2.00. If the trust preferred securities are not converted, they will remain outstanding perpetually unless redeemed by us at any time after January 30, 2011.

On January 30, 2009, we also received from the Treasury an investment of $266.7 million for 266,657 shares of Series C fixed rate cumulative non-convertible perpetual preferred stock and a warrant to purchase up to

approximately 64.5 million shares of our common stock at an exercise price of $0.62 per share. This investment was through the Emergency Economic Stabilization Act of 2008 (initially introduced as the Troubled Asset Relief Program or TARP). The preferred stock pays cumulative dividends quarterly at a rate of 5% per annum for the first five years, and 9% per annum thereafter, and the warrant is exercisable over a 10 year period.

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Pro Forma Capital Ratios

At December 31, 2009, the Bank had regulatory capital ratios that categorized the Bank as well-capitalized pursuant to regulatory standards, with ratios of 6.19% for Tier 1 capital and 11.68% for total risk-based capital. Upon receipt of the $300 million equity investment from MP Thrift on January 27, 2010 as part of our rights offerings, we immediately invested the entire amount into the Bank to further improve its capital level and to fund lending activity. Had the Bank received the $300 million at December 31, 2009, the Bank s regulatory capital ratios would have been 8.16% for Tier 1 capital and 15.28% for total risk-based capital.

Business and Strategy

We, as with the rest of the mortgage industry and most other lenders, were negatively affected in recent years by increased credit losses from the weakening economy. Financial institutions continued to experience significant declines in the value of collateral for real estate loans and heightened credit losses, resulting in record levels of nonperforming assets, charge-offs, foreclosures and losses on disposition of the underlying assets. Moreover, liquidity in the debt markets remained low throughout 2009, further contributing to the decline in asset prices due to the low level of purchasing activity in the marketplace. Financial institutions also face heightened levels of scrutiny and capital and liquidity requirements from regulators.

We believe that despite the increased scrutiny and heightened capital and liquidity requirements, regulated financial institutions should benefit from reduced competition from unregulated entities that lack the access to and breadth of significant funding sources as well as the capital to meet the financing needs of their customers. We further believe that the business model of banking has changed and that full service regional banks will be well suited to take advantage of the changing market conditions.

To that end, we have made significant organizational changes in the past year, which include the appointment of Joseph P. Campanelli as President, Chief Executive Officer and Chairman of the Board, the appointment of several other new executive officers and the addition of new members to the board of directors. Mr. Campanelli has over 30 years of banking experience and played a key leadership role in the transformation of a $10 billion thrift to a $80 billion super community bank. Several other former members of that executive team have also joined us to work toward transforming the Bank into a full-service community bank with a disciplined mortgage banking operation.

We believe that our management team has the necessary experience to appropriately manage through the credit and operational issues that are presented in today s challenging markets. We have put in place a comprehensive program to better align expenses with revenues, a strategic focus to maximize the value of our community banking platform, and a continued emphasis to invest in our position as one of the leading residential mortgage originators in the country.

We intend to continue to seek ways to maximize the value of our mortgage business while limiting risk, with a critical focus on expense management, improving asset quality while minimizing credit losses, increasing profitability, and preserving capital. We expect to pursue opportunities to build our core deposit base through our existing branch banking structure and to serve the credit and non-credit needs of the business customers in our markets, as we diversify our businesses and risk through executing our business plan and transitioning to a full-service community banking model.

We recently identified five key strategies, as further described below, to guide our business: (1) grow assets through expanding into the small and medium-size business market; (2) grow core deposits through cross-selling and retention; (3) leverage our online mortgage origination platform, internet banking technology, and state-of-the-art core banking system; (4) capital preservation and future capital raises; and (5) new management to lead the transformation into a full-service community bank. We believe that our execution of these strategies will: (1) increase revenue

generation, including fee and spread income; (2) improve operating effectiveness; (3) accelerate problem asset resolution and improve asset quality; (4) enhance corporate governance and compliance; and (5) position the operating platform and organizational structure to support growth and diversification. We believe this strategy is consistent with our business plan and with the Supervisory Agreements. See Supervisory Agreements.

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Grow Assets through Expanding into Small Medium-size Business Market.

Our main strategy is to leverage our existing branch network, extensive commercial experience and banking industry knowledge to provide commercial banking services to three primary target markets: (1) micro business market; (2) small business market and (3) middle market (including specialty lending). Products sold to these three market segments will include both credit and non-credit services. We believe our current retail bank branch footprints in Michigan, Indiana and Georgia provide a unique opportunity to leverage existing branches, which are well-maintained and in good locations to expand beyond our historical focus on residential mortgage loan origination. Market research indicates that there are approximately 500,000 small business customers within a five-mile area of our bank branches, none of which are currently significant customers of ours. To optimize this opportunity, we plan to implement a small business customer acquisition strategy, reinvigorate retail and consumer banking, focus our commercial strategy on profitable growth and manage portfolios to optimize value. We also plan to expand our share of wallet from our customers by providing non-credit services and strategic alliances, including merchant services, credit card, consumer/commercial services and cash management. In addition, we plan to assess opportunities to expand our existing footprint into other markets that we believe to be underserved.

Grow Core Deposits through Cross-selling and Retention.

Improve cross-sell ratios. We have introduced a new initiative to increase cross-sell ratios and new customer acquisition through the introduction of new lending products at our banking centers. We believe that offering new lending products will increase relationship profitability and customer retention.

Improve customer satisfaction. We believe that we have enhanced the customer experience through industry leading underwriting turn times, philosophy of one call resolution, robust customer training initiatives, and paperless execution.

Leverage Online Mortgage Origination Platform, Internet Banking Technology, and State-of-the-Art Core Banking System.

Focus on leveraging competitive strengths. We continue to explore opportunities to capitalize on the evolving market place with a focus on maximizing profitability by leveraging our competitive strengths such as the best in class paperless origination platform and our market position as a leading provider of warehouse lines of credit and cash management services to qualified wholesale correspondents.

Core banking system conversion. In February 2010, the Bank converted to a new core banking system, which now enables the Bank to support both retail and commercial business development and growth in a customer-focused fashion as a key part of the Bank s plan to diversify its revenue generation capability by capitalizing on its broad customer base. The system s open architecture and relational database technology supports a single integrated system, providing the Bank with the functionality to compete with larger institutions without having to maintain multiple systems. On an immediate basis, the system provides all the banking centers with the capability to shorten account opening times, improve cross-sell capabilities and improve overall relationship management.

The new system also provides a relational database core processing solution intended to provide the Bank with a competitive edge in operational efficiency and relationship management. It presents a customer-level view rather than the traditional account-level view and thus enables the Bank to manage total customer relationships not just individual accounts.

The new system, which affects teller systems, ATM machines, online banking, item processing, wire transfers and other key banking services, is scalable to handle significant growth in number of transactions and types of product

offerings.

Focus on current mortgage banking operations. Our strategy for 2010 includes focusing on our current mortgage banking operations, and in particular our relationships with Fannie Mae, Freddie Mac and Ginnie Mae (each an Agency or collectively the Agencies), which have allowed us to generate significant income from the sale of loans throughout our history and especially in the year ended December 31, 2009. This

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earnings capability from our sale of loans far exceeds our net interest income generated from our banking operation and has provided us with the ability, in part, to absorb the credit losses that we are experiencing in the current recessionary environment.

Capital Preservation and Future Capital Raises.

Our goals include capital preservation through engaging in additional capital raises to improve capital levels and managing expenses and credit losses to reduce erosion of capital.

Management of troubled assets. We have taken measures to mitigate risk and resolve potential loss situations arising from the industry-wide credit issues. In recent years, we have incurred substantial credit costs related to asset quality issues. However, our balance sheet contains a significant seasoned static pool as loans have not been originated for investment since 2007. To address the asset quality issues in this static pool, we have taken various steps, including increasing resources and oversight over loss mitigation, realignment of quality control and fraud management departments, and establishing customized workout strategies. Over the last 12 months, our commercial lending division has hired workout specialists and developed processes to focus on the workout of commercial real estate problems by comprehensively addressing the credit aspects of the portfolio, especially those in workout or loans which have been foreclosed upon and thereby converted into real-estate owned. We are committed to improving the quality of assets and are continually reviewing our portfolios with a focus on aggressively pursuing resolutions of non-performing loans. With respect to our commercial real estate portfolio, we are focused on minimizing our exposure by closely monitoring existing commercial loan relationships, proactively anticipating deteriorating commercial loan relationships, and taking decisive and appropriate action, legal or otherwise, on a consistent basis.

Future capital raises. In addition to the actions above, we may also attempt to raise additional capital pursuant to offerings of our equity securities. We may attempt to do so through private and public offerings. All or substantially all of the proceeds of any such offering would be available for general corporate purposes including contribution to the capital of the Bank.

Aggressively manage costs. We continue to make it a priority to identify cost savings opportunities by: (1) obtaining value for the materials, goods and services purchased; (2) centralizing and optimizing project management; (3) reviewing systems to document and address opportunities to improve processing capability and reduce operating expenses; and (4) improving productivity by reviewing tasks performed in each area and eliminating redundancy.

Minimize default risk exposure. We are working to better leverage our centralized platform, training initiatives, and automated fraud detection tools to minimize default risk exposure and achieve targeted performance levels.

Diversification of assets and management of concentration limits. We will expand our product offerings in order to diversify our income streams as well as establish and maintain appropriate risk profile concentration limits for each asset type. For example, our mortgage banking business provides us with significant earning potential, but also results in the accumulation of mortgage servicing rights that require significant capital and are highly sensitive to interest rate risk and hedging costs. Accordingly, we have actively sought sales and other opportunities to maintain our concentration of the mortgage servicing rights portfolio at levels that we believe to be appropriate given our various risk profiles and capital position.

New Management to Lead Transformation.

Recruit and retain highly competent personnel. We have successfully recruited key executives with deep product knowledge and industry experience to enhance our management team in connection with the implementation of our new organizational structure and business strategy. In connection with our expansion in existing markets, we are

training banking staff to acquire micro market business and are establishing a centralized underwriting capability. Additionally, we expect to form regional small business and commercial banking teams that would be augmented by hiring additional staff where needed.

Commitment to compliance. We are committed to an effective compliance management strategy that reduces risk, promotes operational efficiencies, and fosters high quality customer service. Our compliance management strategy focuses on the fundamental components of a compliance program including system operations, monitoring, assessment, accountability, response and training. In December 2009, we hired a Chief Risk Officer to oversee and continue the development of our enterprise risk management structure.

Branch banking opportunities. We continue to review the performance of our network of banking centers on an ongoing basis and will continue to evaluate individual locations for their potential to grow and contribute to our profitability. While we opened four banking centers during 2009, we also closed 14 banking centers, all but two of which were in-store branches. Currently, we plan to close three branches in 2010, and we believe that the reduction of banking centers will not affect our strategy to promote diversified asset growth through the banking center branch network.

Executive Officers of the Registrant

To facilitate timely and successful execution of our business strategy, we have emphasized the development of our executive leadership team. Our executive officers are highly experienced and accomplished with a record of leading and operating large financial institutions. Their collective experiences include managing both banking and mortgage operations and retail and commercial franchises, expense reductions and control, comprehensive underwriting and credit management experience across multiple asset classes, asset workout and dispositions, the creation of high performing sales cultures, acquisitions and large scale integrations, and producing sustained financial results within a conservative risk framework and an efficient cost structure.

We believe that our executive officers have a significant competitive advantage because most of its members have worked together for numerous years and have executed acquisition, integration and conversion strategies as a team at large-scale, complex banking institutions.

Our executive officers include:

JOSEPH P. CAMPANELLI, 53, has served as President and Chief Executive Officer since September 2009 and Chairman of the Board since November 2009. Mr. Campanelli was President and Chief Executive Officer and a member of the Board of Directors of Sovereign Bancorp, Inc. and Sovereign Bank until September 30, 2008, where he oversaw nearly 750 community banking centers and 12,000 team members. Mr. Campanelli originally joined Sovereign Bank in 1997 when it acquired Fleet Financial Group s automotive finance group, which was headed by Mr. Campanelli. He became President and Chief Operating Officer of Sovereign s New England Division in 1999 when Sovereign acquired 268 branches that Fleet Financial Group divested after its merger with Bank Boston Corp. Mr. Campanelli played an active role in the branch acquisition and integration, which at the time was the largest branch and business divestiture in U.S. banking history. Mr. Campanelli played a key leadership role in the transformation of Sovereign Bank from a $10 billion thrift to an $80 billion super community bank. Prior to his employment by Sovereign, Mr. Campanelli spent nearly 20 years serving in a variety of senior and executive positions, overseeing commercial and community activities and problem asset resolution, with both Fleet Financial Group and Shawmut Bank. He began his banking career in Hartford, Connecticut in 1979. In his over 30 years experience, Mr. Campanelli has served in a variety of senior and executive positions and has a history of successfully managing through a variety of economic conditions, with a track record of leading transformational change.

SALVATORE J. RINALDI, 55, has served as Executive Vice President and Chief of Staff since October 2009. Mr. Rinaldi was Executive Vice President and Chief of Staff of Sovereign Bancorp, Inc. until February 2009. Mr. Rinaldi joined Sovereign Bancorp in August 1998 and, served in a variety of senior positions

including managing all acquisitions and major system conversions for the organization. Mr. Rinaldi oversaw the integration of the Fleet/Bank Boston branches for Sovereign. At Sovereign, Mr. Rinaldi also managed the post-acquisition integration of nine financial institutions with asset sizes ranging from $250 million to $15 billion, and converted most major systems for the company. Additionally, Mr. Rinaldi managed most corporate and special projects initiatives for Sovereign and supervised the IT, Operations and Administrative functions. Prior to Sovereign,

Mr. Rinaldi worked for 25 years in the banking industry, during which he held a number of senior and executive positions at Fleet Bank, Shawmut Bank and Connecticut National Bank.

PAUL D. BORJA, 49, has served as Executive Vice President since May 2005 and Chief Financial Officer since June 2005. Mr. Borja has worked with the banking industry for more than 25 years, including as an audit and tax CPA with a Big 4 accounting firm and others from 1982 through 1990 specializing in financial institutions. He also practiced as a banking, corporate, tax and securities attorney in Washington DC from 1990 through 2005, where he assisted with or managed mergers and acquisitions of banks and thrifts, structured the corporate and tax aspects of mergers ranging in asset size from $50 million to $13 billion, managed initial public offerings and public and private secondary offerings of debt and equity, provided bank regulatory advice and assisted with accounting standard interpretations and reviews of financial processes. Mr. Borja is also a member of the board of directors of the Federal Home Loan Bank of Indianapolis and serves as vice chairman of the board s Finance Committee.

TODD MCGOWAN, 46, has served as Executive Vice-President and Chief Risk Officer since December 2009. Mr. McGowan has over 20 years experience in performing compliance audits and improving performance for many Fortune 500 public and private companies in the financial services and manufacturing industries. From 1998 until 2009, Mr. McGowan was a Partner with Deloitte & Touche LLP, and, among other things, developed and implemented Sarbanes-Oxley compliance programs, developed and managed internal audits of Sarbanes-Oxley compliance programs, implemented enterprise risk management programs, and developed risk assessment techniques and risk mitigation strategies for financial institutions ranging in size from $500 million to $20 billion in Michigan and Ohio.

MATTHEW A. KERIN, 55, has served as Executive Vice President and Managing Director, Consumer Banking & Specialty Groups, since November 2009. Mr. Kerin has more than twenty years experience in banking, most recently having served as Executive Vice-President and Managing Director, Corporate Specialties at Sovereign Bank. He was responsible for mortgage banking, home equity underwriting and credit cards, auto finance, capital markets, private banking, investment sales cash management, trade finance and government banking. Prior to joining Sovereign in 2006, Mr. Kerin held executive operating and administrative positions with Columbia Management, the investment management arm of Bank of America and FleetBoston. Previously, he was Executive Vice-President and Managing Director, Corporate Strategy & Development at FleetBoston and FleetBank where he was involved in the development and execution of corporate strategic initiatives , the corporate merger and acquisition program, and the Project Management Office for numerous large acquisitions. Prior to Fleet, Mr. Kerin held senior management roles at Shawmut Bank and Hartford National Bank, including mergers and acquisitions, real estate workout, corporate finance and investment banking. Throughout his career, Mr. Kerin has successfully overseen several billion dollars of transactions involving the purchase and sale of a wide variety of businesses, assets and deposits. He began his financial services career at Hartford National Bank in 1986.

ALESSANDRO DINELLO, 55, has served as Executive Vice President and Head of Retail Banking since 1995. In that role, Mr. DiNello grew the bank branch network from five locations, principally in outstate Michigan, to 175 locations throughout Michigan and Indiana and in the north Atlanta, Georgia area, all on a de novo basis. Included in this expansion was the development of an in-store banking platform, principally in partnership with Wal-Mart in all three States. Mr. DiNello was also responsible for forming a Government Banking group that has competed very effectively in both Michigan and Indiana, as well as an Internet Banking group that has competed effectively on a national basis. Prior to serving as our Head of Retail Banking, Mr. DiNello served as President of Security Savings Bank, which in 1996 was merged with First Security Savings Bank to form Flagstar Bank. Mr. DiNello began his employment with Security Savings Bank in 1979. He was instrumental in converting Security from a mutual to a stock organization in 1984, and

in 1994, he was instrumental in negotiating the sale of Security to First Security at a price that resulted in a return of almost 600% to Security s charter stockholders. He also served as a Bank Examiner with the Federal Home Loan Bank

Board from 1976 through 1979. Mr. DiNello serves on the board of directors of the Michigan Banker s Association and represents it on the American Banker s Association s Government Relations Administrative Committee.

MARSHALL SOURA, 70, has served as Executive Vice-President and Director of Corporate Services since October 2009. Mr. Soura has over 40 years of banking industry experience, most recently as Chairman of the Board and Chief Executive Officer of Sovereign Bank s Mid-Atlantic Division and Executive Vice-President with responsibility for all retail and commercial banking operations in the Mid-Atlantic Division until September 2008. Previously at Sovereign, Mr. Soura served as Executive Vice-President and Managing Director of the Global Solutions Group and Marketing Department overseeing the cash management, international trade banking, government banking, financial institutions and strategic alliances business units. Prior to joining Sovereign, Mr. Soura served in a variety of executive positions at BankBoston, BankOne, Bank of America and Girard Bank (Mellon Bank East).

MATTHEW I. ROSLIN, 42, has served as Chief Legal Officer of the Bank since April 2004, Executive Vice President since 2005 and Chief Administrative Officer since 2009. Prior to joining the Bank, Mr. Roslin was Executive Vice President, Corporate Development of MED3000 Group, Inc., a privately held healthcare management company that he joined in 1996 as its General Counsel. During his tenure with MED3000, Mr. Roslin served on the Board of Directors and helped transition the company from a virtual startup to a national healthcare management company with over 1,700 employees and operations in 14 states. Prior to joining MED3000, Mr. Roslin practiced corporate law at Jones Day and Dewey Ballantine from 1991 through 1997, with a focus on mergers and acquisitions in the health care, retail and financial services industries, ranging in asset size of up to $30 billion.

Our management team has long standing relationships with leading bankers and industry experts, including senior commercial and small business officers and retail and consumer banking professionals. We believe that the management team can be leveraged to bring in expertise as well as to give us immediate access to key skill sets and quality customers.

Operating Segments

Our business is comprised of two operating segments banking and home lending. Our banking operation currently offers a line of consumer and commercial financial products and services to individuals. Our strategy provides that we will also offer such services in our retail footprint to small and middle market businesses, all of which are expected to occur through our network of bank branches and our online services. Our home lending operation originates, acquires, sells and services mortgage loans on one-to-four family residences. Each operating segment supports and complements the operations of the other, with funding for the home lending operation primarily provided by deposits and borrowings obtained through the banking operation. Financial information regarding our two operating segments is set forth in Note 30 of the Notes to Consolidated Financial Statements, in Item 8. Financial Statements and Supplementary Data. A more detailed discussion of our two operating segments is set forth below.

Banking Operation. Our banking operation is composed of three delivery channels: Branch Banking, Internet Banking and Government Banking.

Branch Banking consists of 165 banking centers located throughout the State of Michigan and also in Indiana (principally in the Indianapolis Metropolitan Area) and Georgia (principally in the north Atlanta suburbs).

Internet Banking is engaged in deposit gathering (principally money market deposit accounts and certificates of deposits) on a nationwide basis, delivered primarily through FlagstarDirect.com.

Government Banking is engaged in providing deposit and cash management services to governmental units on a relationship basis throughout key markets, including Michigan and Indiana and, to a lesser degree, in Georgia.

The Bank s retail strategy (Branch Banking and Internet Banking) revolves around two major initiatives: improving cross sales ratios with existing customers and increasing new customer acquisition.

To improve cross sale ratios with existing customers, 10 primary products have been identified as key products on which to focus our sales efforts. These products produce incremental relationship profitability and/or improve customer retention. Key products include mortgage loans, bill pay (with online banking), debit/credit cards, direct deposit money market demand accounts, checking accounts, savings accounts, certificates of deposit, lines of credit, consumer loans and investment products. At December 31, 2009, the Bank s cross sales ratio using this product set was 2.81. Strategies have been formulated and implemented to improve this ratio.

To increase new customer acquisition, we have performed customer segmentation analyses to structure on-boarding strategies. The Bank has identified the consumer profiles that best match the Bank s product and service platform. After determining the propensity of each customer to purchase specific products offerings, the Bank then markets to those customers with a targeted approach. This includes offering banking products to mortgage customers, including those mortgage customers who reside within the branch banking footprint and have a loan that we service.

A major initiative to assist in the cross sales improvement and new customer acquisition is the introduction of lending products to the Branch Banking delivery channel. Previously, no lending products were offered directly by bank branches. We believe the ability to offer lending products to retail customers is essential to relationship profitability and customer retention. Going forward, we expect to offer additional lending products directly through bank branches, including various consumer loans, credit cards and business loans, including an expanded array of business banking deposit products and services.

To further improve net interest margin, the banking operation plans to acquire high quality deposits through the following strategic focuses**:**

- Growing core deposits.
- Disciplined pricing of deposits.
- Growing checking accounts to enhance fee income, and cross-sell potential into other financial products.
- Maintaining best in class customer service to enhance, retention and increase word of mouth customer referrals.
- Leveraging technology to enhance customer acquisition and retention:
  - Provide a comprehensive online banking platform (consumer and business) to improve retention.
    - Increase percentage of customers using online banking.
    - Increase percentage of online banking customers using bill pay and direct deposit.
  - Utilize website analytics to understand customer web traffic and keep the website updated with fresh content

Establish improved mobile banking and social networking platforms to enhance customer acquisition and retention.

Optimize key Internet Banking ratios through website improvements, active site traffic monitoring and online application usability.

In addition to improving the effective use of our bank branches, we expect to opportunistically expand our bank branch network.

The Bank s Government Banking strategy is focused on expanding the number of full relationships through leveraging outstanding customer service levels, expanding its customer base in Michigan and Indiana and increasing the number and types of products sold to customers in Georgia.

In addition to deposits, we may borrow funds by obtaining advances from the FHLBI or other federally backed institutions or by entering into repurchase agreements with correspondent banks using as collateral our mortgage-backed securities that we hold as investments. The banking operation may invest these funds in a variety of consumer and commercial loan products.

Home Lending Operation. Our home lending operation originates, acquires, sells and services one-to-four family residential mortgage loans. The origination or acquisition of residential mortgage loans constitutes our most significant lending activity. At December 31, 2009, we held approximately 62.6% of our interest-earning assets in first mortgage loans on single-family residences.

During 2009, we were one of the country s leading mortgage loan originators. We utilize three production channels to originate or acquire mortgage loans Retail, Broker and Correspondent. Each production channel produces similar mortgage loan products and applies, in most instances, the same underwriting standards. We expect to continue to leverage our technology to streamline the mortgage origination process and bring service and convenience to our brokers and correspondents. We maintain eight sales support offices that assist our brokers and correspondents nationwide. We also continue to make increasing use of the Internet as a tool to facilitate the mortgage loan origination process through our production channels. Our brokers, correspondents and home loan centers are able to register and lock loans, check the status of in-process inventory, deliver documents in electronic format, generate closing documents, and request funds through the Internet. Virtually all mortgage loans that closed in 2009 used the Internet in the completion of the mortgage origination or acquisition process.

Retail. In a retail transaction, we originate the loan through our nationwide network of stand-alone home loan centers, as well as referrals from our 165 banking centers located in Michigan, Indiana and Georgia and our national call center located in Troy, Michigan. When we originate loans on a retail basis, we complete the origination documentation inclusive of customer disclosures and other aspects of the lending process and fund the transaction internally. In 2009, we reduced the number of stand-alone home loan centers from 104 at year-end 2008 to 23 at year-end 2009 to drive profitability and expect in 2010 to allocate additional, dedicated home lending resources towards developing lending capabilities in our 165 banking centers and our consumer direct channel. At the same time, we centralized loan processing to gain efficiencies and allow our lending staff to focus on originations. Despite the reduction in home loan centers, during 2009 we closed $4.0 billion of loans utilizing this origination channel, which equaled 11.9% of total originations as compared to $2.6 billion or 9.5% of total originations in 2008 and $2.0 billion or 7.8% of total originations in 2007.

Broker. In a broker transaction, an unaffiliated mortgage brokerage company completes the loan paperwork, but the loans are underwritten on a loan-level basis to our underwriting standards and we supply the funding for the loan at closing (also known as table funding) thereby becoming the lender of record. At closing, the broker may receive an origination fee from the borrower and we may also pay the broker a premium to acquire the loan. We currently have active broker relationships with over 4,700 mortgage brokerage companies located in all 50 states. During 2009, we closed $13.8 billion utilizing this origination channel, which equaled 43.1% of total originations, as compared to $12.2 billion or 44.0% in 2008 and $12.4 billion or 49.3% in 2007.

Correspondent. In a correspondent transaction, an unaffiliated mortgage company completes the loan paperwork and also supplies the funding for the loan at closing. We acquire the loan after the mortgage company has funded the transaction, usually paying the mortgage company a market price for the loan. Unlike

several of our competitors, we do not generally acquire loans in bulk amounts from correspondents but rather, we acquire each loan on a loan-level basis and require that each loan be originated to our underwriting guidelines. We have active correspondent relationships with over 1,200 companies, including banks and mortgage companies, located in all 50 states. Over the years, we have developed what we believe to be a competitive advantage as a warehouse lender, wherein we

provide lines of credit to mortgage companies to fund their loans. Warehouse lending is not only a profitable, stand-alone business for us, but also provides valuable synergies with our correspondent channel. In today s marketplace, there is high demand for warehouse lending, but we believe that there are only a limited number of experienced providers. We believe that offering warehouse lines has provided us a competitive advantage in the small to midsize correspondent channel and has helped us grow and build out our correspondent business in a profitable manner. For example, in 2009, our warehouse lines funded over 75% of the loans in our correspondent channel. We plan to continue to leverage our warehouse lending as a customer retention and acquisition tool in 2010. During 2009, we closed $14.5 billion utilizing the correspondent origination channel, which equaled 45.0% of total originations versus $13.0 billion or 46.5% originated in 2008 and $10.8 billion or 42.9% originated in 2007.

Underwriting. In past years, we originated a wide variety of residential mortgage loans, both for sale and for our own portfolio, including fixed rate first and second lien mortgage loans, adjustable rate mortgages (ARMs), interest only mortgage loans both ARM and fixed, and to a far lesser extent, potential negative amortization payment option ARMs (option power ARMs), subprime loans, and home equity lines of credit (HELOCs). We also originated commercial real estate loans for our own portfolio.

As a result of our increasing concerns about nationwide economic conditions, in 2007, we began to reduce the number and types of loans that we originated for our own portfolio in favor of sale into the secondary market. In 2008, we halted originations of virtually all types of loans for our held-for-investment portfolio and focused on the origination of residential mortgage loans for sale.

During 2009, we primarily originated residential mortgage loans for sale that conformed to the respective underwriting guidelines established by the Agencies. Loans placed in the held-for-investment portfolio in 2009 would comprise either loans that were repurchased or, on a very limited basis, loans that were originated to assist with the sale of our real estate owned (REO).

First Mortgage Loans

At December 31, 2009, most of our held-for-investment mortgage loans were originated in prior years with underwriting criteria that varied by product and with the standards in place at the time of origination.

Set forth below is a table describing the characteristics of the first mortgage loans in our held-for-investment portfolio at December 31, 2009, by year of origination (also referred to as the vintage year , or vintage).

Year of Origination	**2006 and Prior**	**2007**	**2008**	**2009**	**Total**
		(Dollars in thousands)			
Unpaid principal balance(1)	$ 3,061,627	$ 1,755,393	$ 103,279	$ 27,898	$ 4,948,197
Average note rate	5.17%	6.18%	6.12%	5.42%	5.55%
Average original FICO score	715	720	691	694	716
Average original loan-to-value ratio	74.4%	74.5%	82.7%	86.1%	74.7%
Average original combined loan-to- value ratio	78.0%	77.5%	84.1%	89.9%	78.0%
Underwritten with low or stated income documentation	33.0%	56.0%	19.0%	5.0%	41.0%

(1) Unpaid principal balance does not include premiums or discounts.

First mortgage loans are underwritten on a loan-by-loan basis rather than on a pool basis. Generally, mortgage loans produced through our production channels are reviewed by one of our in-house loan underwriters or by a contract underwriter employed by a mortgage insurance company. However, a limited number of our correspondents have been delegated underwriting authority but this has not comprised more than 12% of the loans originated in any year. In all cases, loans must be underwritten to our underwriting standards. Any loan not underwritten by our employees must be warranted by the underwriter s employer,

which may be a mortgage insurance company or a correspondent mortgage company with delegated underwriting authority.

Our criteria for underwriting generally included, but were not limited to, full documentation of borrower income and other relevant financial information, fully indexed rate consideration for variable loans, and for Agency loans, the specific Agency s eligible loan-to-value ratios with full appraisals when required. Variances from any of these standards were permitted only to the extent allowable under the specific program requirements. These included the ability to originate loans with less than full documentation and variable rate loans with an initial interest rate less than the fully indexed rate. Mortgage loans were collateralized by a first or second mortgage on a one-to-four family residential property.

In general, loan balances under $1,000,000 required a valid Agency automated underwriting system (AUS) response for approval consideration. Documentation and ratio guidelines were driven by the AUS response. A FICO credit score for the borrower was required and a full appraisal of the underlying property that would serve as collateral was obtained.

For loan balances over $1,000,000, traditional manual underwriting documentation and ratio requirements were required as were two years plus year to date of income documentation and two months of bank statements. Income documentation based solely on a borrower s statement was an available underwriting option for each loan category. Even so, in these cases employment of the borrower was verified under the vast majority of loan programs, and income levels were usually checked against third party sources to confirm validity.

We believe that our underwriting process, which relies on the electronic submission of data and images and is based on an award-winning imaging workflow process, allows for underwriting at a higher level of accuracy and with more timeliness than exists with processes which rely on paper submissions. We also provide our underwriters with integrated quality control tools, such as automated valuation models (AVMs), multiple fraud detection engines and the ability to electronically submit IRS Form 4506s to ensure underwriters have the information that they need to make informed decisions. The process begins with the submission of an electronic application and an initial determination of eligibility. The application and required documents are then faxed or uploaded to our corporate underwriting department and all documents are identified by optical character recognition or our underwriting staff. The underwriter is responsible for checking the data integrity and reviewing credit. The file is then reviewed in accordance with the applicable guidelines established by us for the particular product. Quality control checks are performed by the underwriting department using the tools outlined above, as necessary, and a decision is then made and communicated to the prospective borrower.

The following table identifies, at December 31, 2009, our held-for-investment mortgages by major category and describes the current portfolio with unpaid principal balance, average note rate, average original FICO score, average original combined loan-to-value ratio (CLTV), the weighted average maturity and the related housing price index. The housing price index (HPI) loan-to-value (LTV) is updated from the original LTV based on Metropolitan Statistical Area (MSA)-level Office of Federal Housing Enterprise Oversight data. Loans categorized as subprime were initially originated for sale and comprised only 0.1% of the portfolio of first liens. Within the first lien residential mortgage loan portfolio, high LTV loan originations, defined as loans with a 95% LTV or greater at origination, comprised only 6% of our held-for-investment loan portfolio. Our risk of loss on these loans is mitigated because private mortgage insurance was required on the vast majority of loans with LTVs exceeding 80% at the time of origination.

	Unpaid Principal Balance(1)	Average Note Rate	Average Original FICO Score	Average Original Combined Loan-to-Value Ratio	Weighted Average Maturity	Housing Price Index LTV
			(Dollars in thousands)			
First mortgage loans:						
Amortizing:						
3/1 ARM	$ 251,472	4.83%	685	82.7%	283	83.07%
5/1 ARM	$ 639,153	5.00%	714	75.7%	298	73.76%
7/1 ARM	$ 76,525	5.68%	727	75.6%	304	84.35%
Other ARM	$ 112,963	4.69%	671	84.4%	271	81.54%
Other amortizing	$ 926,051	6.22%	712	75.3%	283	83.49%
Interest only:						
3/1 ARM	$ 386,468	5.11%	723	81.5%	271	86.02%
5/1 ARM	$ 1,600,382	5.37%	721	78.8%	299	85.88%
7/1 ARM	$ 131,331	6.08%	727	75.5%	306	93.12%
Other ARM	$ 84,923	5.17%	719	83.2%	306	92.08%
Other interest only	$ 461,216	6.25%	723	77.7%	316	97.65%
Option ARMs	$ 271,570	5.82%	719	76.6%	323	102.80%
Subprime						
3/1 ARM	$ 1,840	7.61%	646	97.8%	296	117.58%
Other ARM	$ 2,096	6.95%	600	85.2%	236	106.08%
Other subprime	$ 2,207	6.85%	580	81.2%	279	96.55%
Total first mortgage loans	$ 4,948,197	5.55%	716	78.0%	296	85.96%
Second mortgages	$ 220,555	8.37%	734	20.0%(2)	153	22.74%(3)
HELOCs	$ 298,975	5.33%	739	25.0%(2)	74	26.02%(3)

(1) Unpaid principal balance does not include premiums or discounts..

(2) Reflects LTV because these are second liens.

(3) Does not reflect any first mortgages that may be outstanding. Instead, incorporates current loan balance as a portion of current HPI value.

The following table sets forth characteristics of those loans in our held-for-investment mortgage portfolio as of December 31, 2009 that were originated with less documentation than is currently required. Loans as to which underwriting information was accepted from a borrower without validating that particular item of information is referred to as low doc or stated. Substantially all of those loans were underwritten with verification of employment but with the related job income or personal assets, or both, stated by the borrower without verification of actual amount. Those loans may have additional elements of risk because information provided by the borrower in connection with the loan was limited. Loans as to which underwriting information was supported by third party documentation or procedures is referred to as full doc and the information therein is referred to as verified. Also set forth are different types of loans that may have a higher risk of non-collection than other loans.

	Low Doc		
	% of Held-for-Investment Portfolio		Unpaid Principal Balance(1)
	(Dollars in thousands)		
Characteristics			
SISA (stated income, stated asset)	2.61%	$	200,503
SIVA (stated income, verified assets)	17.52%	$	1,345,625
High LTV (i.e., at or above 95%)	0.27%	$	20,708
Second lien products (HELOCs, Second mortgages)	1.94%	$	148,878
Loan types:			
Option ARM loans	2.50%	$	191,870
Interest-only loans	15.04%	$	1,155,286
Subprime	0.04%	$	3,077

(1) Unpaid principal balance does not include premiums or discounts.

ARMs

ARM loans held for investment were originated using Fannie Mae and Freddie Mac guidelines as a base framework, and the debt-to-income ratio guidelines and documentation typically followed the AUS guidelines. Our underwriting guidelines were designed with an intent to minimize layered risk. The maximum ratios allowable for purposes of both the LTV ratio and the CLTV ratio, which includes second mortgages on the same collateral, was 100%, but subordinate (i.e., second mortgage) financing was not allowed over a 90% LTV ratio. At a 100% LTV ratio with private mortgage insurance, the minimum acceptable FICO score, or the floor, was 700, and at lower LTV ratio levels, the FICO floor was 620. All occupancy and specific-purpose loan types were allowed at lower LTVs. At times ARMs were underwritten at an initial rate, also known as the start rate , that was lower than the fully indexed rate but only for loans with lower LTV ratios and higher FICO scores. Other ARMs were either underwritten at the note rate if the initial fixed term was two years or greater, or at the note rate plus two percentage points if the initial fixed rate term was six months to one year.

Adjustable rate loans were not consistently underwritten to the fully indexed rate until the Interagency Guidance on Nontraditional Mortgage Products issued by the federal banking regulatory agencies was released in 2006. Teaser rates (i.e., in which the initial rate on the loan was discounted from the otherwise applicable fully indexed rate) were only offered for the first three months of the loan term, and then only on a portion of ARMs that had the negative amortization payment option available and HELOCs. Due to the seasoning of our portfolio, all borrowers have

adjusted out of their teaser rates at this time.

Option power ARMs, which comprised 5.49% of the first mortgage portfolio as of December 31, 2009, are adjustable rate mortgage loans that permit a borrower to select one of three monthly payment options when the loan is first originated: (i) a principal and interest payment that would fully repay the loan over its stated term, (ii) an interest-only payment that would require the borrower to pay only the interest due each month but would have a period (usually 10 years) after which the entire amount of the loan would need to be repaid (i.e., a balloon payment) or refinanced, and (iii) a minimum payment amount selected by the borrower

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and which might exclude principal and some interest, with the unpaid interest added to the balance of the loan (i.e., a process known as negative amortization).

Option power ARMS were originated with maximum LTV and CLTV ratios of 95%; however, subordinate financing was only allowed for LTVs of 80% or less. At higher LTV/CLTV ratios, the FICO floor was 680, and at lower LTV levels the FICO floor was 620. All occupancy and purpose types were allowed at lower LTVs. The negative amortization cap, i.e., the sum of a loan s initial principal balance plus any deferred interest payments, divided by the original principal balance of the loan, was generally 115%, except that the cap in New York was 110%. In addition, for the first five years, when the new monthly payment due is calculated every twelve months, the monthly payment amount could not increase more than 7.5% from year to year. By 2007, option power ARMs were underwritten at the fully indexed rate rather than at a start rate. At December 31, 2009, we had $271.6 million of option power ARM loans in our held-for-investment loan portfolio, and the amount of negative amortization reflected in the loan balances at December 31, 2009 was $16.2 million. The maximum balance that all option power ARMs could reach cumulatively is $295.8 million.

Set forth below is a table describing the characteristics of our ARM loans in our held-for-investment mortgage portfolio at December 31, 2009, by year of origination.

Year of Origination	2006 and Prior	2007	2008	2009	Total
	(Dollars in thousands)				
Unpaid principal balance(1)	$ 2,635,467	$ 861,673	$ 48,565	$ 13,018	$ 3,558,723
Average note rate	5.02%	6.05%	5.82%	5.14%	5.28%
Average original FICO score	715	719	717	690	716
Average original loan-to-value ratio	74.8%	75.0%	80.4%	82.3%	74.9%
Average original combined loan-to-value ratio	78.8%	78.3%	84.0%	90.8%	78.8%
Underwritten with low or stated income documentation	35.0%	60.0%	22%	10%	41%

(1) Unpaid principal balance does not include premiums or discounts.

Set forth below is a table describing specific characteristics of option power ARMs in our held-for-investment mortgage portfolio at December 31, 2009, by year of origination:

Year of Origination	2006 and Prior	2007	2008	2009	Total
	(Dollars in thousands)				
Unpaid principal balance(1)	$ 77,793	$ 193,777	$	$	$ 271,570
Average note rate	5.19%	6.07%			5.82%
Average original FICO score	708	724			719
Average original loan-to-value ratio	72.8%	72.4%			72.5%
Average original combined loan-to- value ratio	75.8%	76.9%			76.6%
Underwritten with low or stated income documentation	$ 41,765	$ 150,105	$	$	$ 191,870

Total principal balance with any accumulated negative amortization ($)	$ 70,039	$ 188,192	$	$	$ 258,231
Percentage of total ARMS with any accumulated negative amortization	3.0%	22.0%			7.0%
Amount of negative amortization (i.e., deferred interest) accumulated as interest income as of 12/31/09	$ 4,999	$ 11,220	$	$	$ 16,219

(1) Unpaid principal balance does not include premiums or discounts.

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Set forth below are the amounts of interest income arising from the net negative amortization portion of loans and recognized during the year ended December 31:

	Unpaid Principal Balance of Loans in Negative Amortization At Year-End(1)	Amount of Net Negative Amortization accumulated as interest income during period
	(Dollars in thousands)	
2009	$ 258,231	$ 16,219
2008	$ 314,961	$ 14,787
2007	$ 98,656	$ 4,244

(1) Unpaid principal balance does not include premiums or discounts.

Set forth below are the frequencies at which the ARM loans outstanding at December 31, 2009, will reprice:

Reset frequency	# of Loans	Balance	% of the Total
		(Dollars in thousands)	
Monthly	332	$ 96,817	3.0%
Semi-annually	6,588	2,319,238	70.0%
Annually	5,154	903,398	27.0%
Total	12,074	$ 3,319,453	100.0%

Set forth below as of December 31, 2009, are the amounts of the ARM loans in our held-for-investment loan portfolio with interest rate reset dates in the periods noted. As noted in the above table, loans may reset more than once over a three-year period. Accordingly, the table below may include the same loans in more than one period:

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
	(Dollars in thousands)			
2010	$ 635,890	$ 956,948	$ 984,910	$ 1,041,003
2011	$ 1,018,750	$ 1,093,129	$ 1,038,688	$ 1,131,904
2012	$ 1,136,488	$ 1,340,724	$ 1,327,327	$ 1,334,665
Later years(1)	$ 1,335,618	$ 1,369,998	$ 1,371,937	$ 1,386,712

(1) Later years reflect one reset period per loan.

The ARM loans were originated with interest rates that are intended to adjust (i.e., reset or reprice) within a range of an upper limit, or cap, and a lower limit, or floor.

Generally, the higher the cap, the more likely a borrower s monthly payment could undergo a sudden and significant increase due to an increase in the interest rate when a loan reprices. Such increases could result in the loan becoming delinquent if the borrower was not financially prepared at that time to meet the higher payment obligation. In the current lower interest rate environment, ARM loans have generally repriced downward, providing the borrower with a lower monthly payment rather than a higher one. As such, these loans would not have a material change in their likelihood of default due to repricing.

Interest Only Mortgages

Both adjustable and fixed term loans were offered with a 10-year interest only option. These loans were originated using Fannie Mae and Freddie Mac guidelines as a base framework. We generally applied the debt-to-income ratio guidelines and documentation using the AUS Approve/Accept response requirements. The LTV and CLTV maximum ratios allowable were 95% and each 100%, respectively, but subordinate financing was not allowed over a 90% LTV ratio. At a 95% LTV ratio with private mortgage insurance, the FICO floor was 660, and at lower LTV levels, the FICO floor was 620. All occupancy and purpose types were allowed at lower LTVs. Lower LTV and high FICO ARMs were underwritten at the start rate, while other ARMs were either underwritten at the note rate if the initial fixed term was two years or greater, and the note rate plus two percentage points if the initial fixed rate term was six months to one year.

Set forth below is a table describing the characteristics of the interest-only mortgage loans at the dates indicated in our held-for-investment mortgage portfolio at December 31, 2009, by year of origination.

Year of Origination	2006 and Prior	2007	2008	2009	Total
	(Dollars in thousands)				
Unpaid principal balance(1)	$ 1,752,052	$ 893,083	$ 21,070	$ 832(2)	$ 2,667,037
Average note rate	5.18%	6.15%	6.26%	3.66%	5.51%
Average original FICO score	722	721	748	617	722
Average original loan-to-value ratio	74.2%	75.1%	78.9%	78.0%	74.6%
Average original combined loan-to-value ratio	79.3%	78.4%	79.4%	78.0%	79.0%
Underwritten with low or stated Income documentation	36.0%	58.0%	24.0%		43.0%

(1) Unpaid principal balance does not include premiums or discounts.

(2) As described earlier, interest only loans placed in portfolio in 2009 comprise loans that were initially originated for sale. There are two loans in this population.

Second Mortgages

The majority of second mortgages we originated were closed in conjunction with the closing of the first mortgages originated by us. We generally required the same levels of documentation and ratios as with our first mortgages. For second mortgages closed in conjunction with a first mortgage loan that was not being originated by us, our allowable debt-to-income ratios for approval of the second mortgages were capped at 40% to 45%. In the case of a loan closing in which full documentation was required and the loan was being used to acquire the borrower s primary residence, we allowed a CLTV ratio of up to 100%; for similar loans that also contained higher risk elements, we limited the maximum CLTV to 90%. FICO floors ranged from 620 to 720, and fixed and adjustable rate loans were available with terms ranging from five to 20 years.

Set forth below is a table describing the characteristics of the second mortgage loans in our held-for-investment portfolio at December 31, 2009, by year of origination.

Year of Origination	Prior to 2007	2007	2008	2009	Total
	(Dollars in thousands)				
Unpaid principal balance(1)	$ 35,536	$ 166,257	$ 16,882	$ 1,880	$ 220,555
Average note rate	7.95%	8.51%	8.08%	6.99%	8.37%
Average original FICO score	717	735	752	718	734
Average original loan-to-value ratio	21.6%	19.7%	18.9%	17.2%	20.0%
Average original combined loan-to-value ratio	89.5%	90.3%	79.0%	94.1%	89.3%

(1) Unpaid principal balance does not include premiums or discounts.

HELOCs

The majority of home equity lines of credit (HELOCs) loans were closed in conjunction with the closing of related first mortgage loans originated and serviced by us. Documentation requirements for HELOC applications were generally the same as those required of borrowers for the first mortgage loans originated by us, and debt-to-income ratios were capped at 50%. For HELOCs closed in conjunction with the closing of a first mortgage loan that was not being originated by us, our debt-to-income ratio requirements were capped at 40 to 45% and the LTV was capped at 80%. The qualifying payment varied over time and included terms such as either 0.75% of the line amount or the interest only payment due on the full line based on the current rate plus 0.5%. HELOCs were available in conjunction with primary residence transactions that required full documentation, and the borrower was allowed a CLTV ratio of up to 100%, for similar loans that also contained higher risk elements, we limited the maximum CLTV to 90%. FICO floors ranged from 620 to 720.

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The HELOC terms called for monthly interest-only payments with a balloon principal payment due at the end of 10 years. At times, initial teaser rates were offered for the first three months.

Set forth below is a table describing the characteristics of the HELOCs in our held-for-investment portfolio at December 31, 2009, by year of origination.

Year of Origination	**2006 and Prior**	**2007**	**2008**	**2009**	**Total**
		(Dollars in thousands)			
Unpaid principal balance(1)	$ 155,266	$ 119,408	$ 23,761	$ 540	$ 298,975
Average note rate(2)	5.33%	5.56%	4.12%	6.30%	5.33%
Average original FICO score	731	739	756	N/A	739
Average original loan-to-value ratio	25.2%	24.3%	27.4%	24.2%	25.0%
Average original combined loan-to-value ratio	79.7%	82.5%	74.2%	88.7%	80.8%

(1) Unpaid principal balance does not include premiums or discounts.

(2) Average note rate reflects the rate that is currently in effect. As these loans adjust on a monthly basis, the average note rate could increase, but would not decrease, as in the current market, the floor rate on virtually all of the loans is in effect.

Commercial Loans

Our commercial loan portfolio is primarily comprised of seasoned commercial real estate loans that are collateralized by real estate properties intended to be income-producing in the normal course of business. During 2006 and 2007, we placed an increased emphasis on commercial real estate lending and on the expansion of our commercial lending business as a diversification from our national residential mortgage lending platform. During 2008 and 2009, as a result of continued economic and regulatory concerns, we funded commercial loans that had previously been underwritten and approved but otherwise halted new commercial lending activity.

The primary factors considered in past commercial credit approvals were the financial strength of the borrower, assessment of the borrower s management capabilities, industry sector trends, type of exposure, transaction structure, and the general economic outlook. Commercial loans were made on a secured, or in limited cases, on an unsecured basis, with a vast majority also being enhanced by personal guarantees of the principals of the borrowing business. Assets used as collateral for secured commercial loans required an appraised value sufficient to satisfy our loan-to-value ratio requirements. We also generally required a minimum debt-service-coverage ratio, other than for development loans, and considered the enforceability and collectability of any relevant guarantees and the quality of the collateral.

As a result of the steep decline in originations, in early 2009, the commercial lending division completed its transformation from a production orientation into one in which the focus is on working out troubled loans, reducing classified assets and taking pro-active steps to prevent deterioration in performing loans. Toward that end, commercial loan officers were largely replaced by experienced workout officers and relationship managers. A comprehensive review, including customized workout plans, were prepared for all classified loans, and risk assessments were prepared on a loan level basis for the entire commercial real estate portfolio.

At December 31, 2009, our commercial real estate loan portfolio totaled $1.6 billion, or 22.3% of our investment loan portfolio, and our non-real estate commercial loan portfolio was $12.3 million, or 0.2% of our investment loan portfolio. At December 31, 2008, our commercial real estate loan portfolio totaled $1.8 billion, or 19.6% of our investment loan portfolio, and our non-real estate commercial loan portfolio was $24.7 million, or 0.3% of our investment loan portfolio. During 2009, we only originated $2.9 million of new commercial loans versus $206.0 million in 2008.

At December 31, 2009, our commercial real estate loans were geographically concentrated in a few states, with approximately $867.1 million (52.9%) of all commercial loans located in Michigan, $219.8 million (13.4%) located in Georgia and $161.3 million (9.8%) located in California.

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The average loan balance in our commercial real estate portfolio was approximately $1.8 million, with the largest loan being $42.2 million. There are approximately 24 loans with more than $10.0 million of exposure, and those loans comprise approximately 25% of the portfolio.

In commercial lending, ongoing credit management is dependent upon the type and nature of the loan. We monitor all significant exposures on a regular basis. Internal risk ratings are assigned at the time of each loan approval and are assessed and updated with each monitoring event. The frequency of the monitoring event is dependent upon the size and complexity of the individual credit, but in no case less frequently than every 12 months. Current commercial collateral values are updated more frequently if deemed necessary as a result of impairments of specific loan or other credit or borrower specific issues. We continually review and adjust our risk rating criteria and rating determination process based on actual experience. This review and analysis process also contributes to the determination of an appropriate allowance for loan loss amount for our commercial loan portfolio.

We also continue to offer warehouse lines of credit to other mortgage lenders. These commercial lines allow the lender to fund the closing of residential mortgage loans. Each extension or drawdown on the line is collateralized by the residential mortgage loan being funded, and in many cases, we subsequently acquire that loan. Underlying mortgage loans must be originated based on our underwriting standards. These lines of credit are, in most cases, personally guaranteed by one or more qualified principal officers of the borrower. The aggregate amount of warehouse lines of credit granted to other mortgage lenders at December 31, 2009, was $1.5 billion, of which $448.6 million was outstanding, as compared to, $1.1 billion granted at December 31, 2008, of which $434.1 million was outstanding.

The following table identifies our commercial loan portfolio by major category and selected criteria at December 31, 2009:

	Unpaid Principal Balance(1)	Average Note Rate	Commercial Loans on Non-accrual Status
		(Dollars in thousands)	
Commercial real estate loans:			
Fixed rate	$ 1,468,533	6.35%	$ 246,670
Adjustable rate	141,581	7.43%	127,912
Total commercial real estate	$ 1,610,114	6.45%	$ 374,582
Commercial non-real estate loans:			
Fixed rate	$ 10,275	8.18%	$ 4,460
Adjustable rate	2,013	6.10%	206
Total commercial non-real estate	$ 12,288	7.85%	$ 4,666
Warehouse lines of credit			
Adjustable rate	$ 448,567	5.45%	$
Total warehouse lines of credit	$ 448,567	5.45%	$

(1) Unpaid principal balance does not include premiums or discounts.

Secondary Market Loan Sales and Securitizations. We sell a majority of the mortgage loans we produce into the secondary market on a whole loan basis or by first securitizing the loans into mortgage-backed securities.

The following table indicates the breakdown of our loan sales/securitizations for the period as indicated:

	For the Year Ended December 31,		
	2009 Principal Sold %	2008 Principal Sold %	2007 Principal Sold %
Agency Securitizations	95.3%	98.2%	89.7%
Whole Loan Sales	4.7%	1.8%	6.5%
Private Securitizations	0.0%	0.0%	3.8%
Total	100.0%	100.0%	100.0%

Most of the mortgage loans that we sell are securitized through the Agencies. In an Agency securitization, we exchange mortgage loans that are owned by us for mortgage-backed securities that are guaranteed by Fannie Mae or Freddie Mac or insured through Ginnie Mae and are collateralized by the same mortgage loans that were exchanged. Most or all of these mortgage-backed securities may then be sold to secondary market investors, which may be the Agencies or other third parties in the secondary market. We receive cash payment for these securities upon the settlement dates of the respective sales, at which time we also transfer the related mortgage-backed securities to the purchaser.

From late 2005 through early 2007, we also securitized most of our second lien mortgage loans through a process which we refer to as a private-label securitization, to differentiate it from an Agency securitization. In a private-label securitization, we sold mortgage loans to our wholly-owned bankruptcy remote special purpose entity, which then sold the mortgage loans to a separate, transaction-specific trust formed for this purpose in exchange for cash and certain interests in the trust and those mortgage loans. Each trust then issued and sold mortgage-backed securities to third party investors that are secured by payments on the mortgage loans. These securities were rated by two of the nationally recognized statistical rating organizations (i.e. rating agencies.) We have no obligation to provide credit support to either the third-party investors or the trusts, although we are required to make certain servicing advances with respect to mortgage loans in the trusts. Neither the third-party investors nor the trusts generally have recourse to our assets or us, nor do they have the ability to require us to repurchase their mortgage-backed securities. We did not guarantee any mortgage-backed securities issued by the trusts. However, we did make certain customary representations and warranties concerning the mortgage loans as discussed below, and if we are found to have breached a representation or warranty, we could be required to repurchase the mortgage loan from the applicable trust. Each trust represents a qualifying special purpose entity, or QSPE, as defined under accounting guidance related to servicing assets and liabilities and therefore the trust was not required to be consolidated for financial reporting purposes. Effective January 1, 2010, we became subject to new accounting rules that eliminated the QSPE designation and its related de-consolidation effect. Instead, each such entity must now be analyzed as to whether it constitutes a variable interest entity, or VIE, and whether, depending upon such characterization, the trust must be consolidated for financial reporting purposes. Based on our analysis, we do not believe that such trusts are required to be consolidated.

In addition to the cash we receive from the securitization of mortgage loans, we retain certain interests in the securitized mortgage loans and the trusts. Such retained interests include residual interests, which arise as a result of our private-label securitizations, and mortgage servicing rights (MSRs), which can arise as a result of our Agency securitizations, whole loan sales or private-label securitizations.

The residual interests created upon the issuance of private-label securitizations represent the first loss position and are not typically rated by any nationally recognized statistical rating organization. The value of residual interests represents the present value of the future cash flows expected to be received by us from the excess cash flows created in the securitization transaction. Excess cash flows are dependent upon various factors including estimated prepayment speeds, credit losses and over-collateralization requirements. Residual interests are not typically entitled to any cash flows until both the over-collateralization account, which represents the difference between the bond balance and the value of the collateral underlying the security, has reached a certain level and certain expenses are paid. The over-collateralization requirement may increase if certain events occur, such as increases in delinquency rates or cumulative losses. If certain expenses are not

paid or over-collateralization requirements are not met, the trustee applies cash flows to the over-collateralization account until such requirements are met and no excess cash flows would flow to the residual interest. A delay in receipt of, or reduction in the amount of, excess cash flows would result in a lower valuation of the residual interests.

Residual interests are designated by us as trading securities and are marked to market in current period operations. We use an internally maintained model to value the residual interest. The model takes into consideration the cash flow structure specific to each transaction, such as over-collateralization requirements and trigger events, and key valuation assumptions, including credit losses, prepayment rates and discount rates. See Note 9 of the Notes to Consolidated Financial Statements, in Item 8 Financial Statements and Supplementary Data, herein.

Upon our sale of mortgage loans, we may retain the servicing of the mortgage loans, or even sell the servicing rights to other secondary market investors. In general, we do not sell the servicing rights to mortgage loans that we originate for our own portfolio or that we privately securitize. When we retain MSRs, we are entitled to receive a servicing fee equal to a specified percentage of the outstanding principal balance of the loans. We may also be entitled to receive additional servicing compensation, such as late payment fees and earn additional income through the use of non-interest bearing escrows.

When we sell mortgage loans, whether through Agency securitizations, private-label securitizations or on a whole loan basis, 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. 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 might 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, actual credit losses on repurchased loans, loss indemnifications and recovery history, 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 amount of our secondary market reserve equaled $66.0 million and $42.5 million at December 31, 2009 and 2008, respectively.

Loan Servicing. The home lending operation also services mortgage loans for others. Servicing residential mortgage loans for third parties generates fee income and represents a significant business activity for us. 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. On January 1, 2008, we adopted accounting guidance within ASC Topic 820, Fair Value Measurements and Disclosures and elected accounting guidance within ASC Topic 860, Transfers and Servicing. Upon our election of the former, the carrying value of our residential MSRs increased to the fair value amount as a result of recognizing a cumulative effect adjustment of $43.7 million to beginning retained earnings. During 2009, 2008 and 2007, we serviced portfolios of mortgage loans that averaged $58.5 billion, $46.2 billion and $23.4 billion, respectively. The servicing generated gross revenue of $158.3 million, $148.5 million and $91.1 million in 2009, 2008, and 2007, respectively. This revenue stream was offset by the amortization of $2.4 million, $2.5 million and $78.3 million in previously capitalized values of MSRs in 2009, 2008, and 2007, respectively. Prior to January 1, 2008, when a loan was prepaid or refinanced, any remaining MSR for that loan would be fully amortized and therefore amortization expense in a period could exceed loan administration income. During a period of falling or low interest rates, the amount of amortization expense typically increased because of prepayments and refinancing of the underlying mortgage loans. During a period of higher or rising interest rates, payoffs and refinancing typically slowed, reducing the rate of amortization. Beginning on January 1, 2008, with the adoption of the fair value method for our residential MSRs, amortization expense is no longer recorded because the fair value estimate uses a valuation model

that calculates the present value of estimated future net servicing cash flows by 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.

As part of our business model, we periodically sell MSRs into the secondary market, in transactions separate from the sale of the underlying loans, principally for capital management, balance sheet management or interest rate risk purposes. Over the past three years, we sold $20.7 billion of loans serviced for others underlying our MSRs, including $16.6 billion in 2009 and we have committed to sell approximately $11 billion in March 2010. Prior to January 1, 2008, at the time of the sale, we recorded a gain or loss based on the selling price of the MSRs less the carrying value and transaction costs. Effective January 1, 2008, with adoption of fair value accounting for residential MSRs, we would not expect to realize significant gains or losses while we still record a gain or loss on sale, at the time of sale as the change in value is recorded as a mark to market adjustment on an on-going basis.

Other Business Activities

We conduct business through a number of wholly-owned subsidiaries in addition to the Bank.

Douglas Insurance Agency, Inc. Douglas Insurance Agency, Inc. (Douglas) acts as an agent for life insurance and health and casualty insurance companies. Douglas also acts as a broker with regard to certain insurance product offerings to employees and customers. Douglas activities are not material to our business.

Flagstar Reinsurance Company. Flagstar Reinsurance Company (FRC) is our wholly-owned subsidiary that was formed during 2007 as a successor in interest to another wholly-owned subsidiary, Flagstar Credit Inc., a reinsurance company which was subsequently dissolved in 2007. FRC is a reinsurance company that provides credit enhancement with respect to certain pools of mortgage loans underwritten and originated by us during each calendar year. With each pool, all of the primary risk is initially borne by one or more unaffiliated private mortgage insurance companies. A portion of the risk is then ceded to FRC by the insurance company, which remains principally liable for the entire amount of the primary risk. To effect this, the private mortgage insurance company provides loss coverage for all foreclosure losses up to the entire amount of the insured risk with respect to each pool of loans. The respective private mortgage insurance company then cedes a portion of that risk to FRC and pays FRC a corresponding portion of the related premium. The mortgage insurance company usually retains the portion of the insured risk ranging from 0% to 5.0% and from 10.01% to 100.0% of the insured risk. FRC s share of the total amount of the insured risk is an intermediate tranche of credit enhancement risk which covers the 5.01% to 10.0% range, and therefore its maximum exposure at any time equals 5.0% of the insured risk of the insured pools. Pursuant to our individual agreements with the private mortgage insurance companies, we are obligated to maintain cash in a separately managed account for the benefit of these mortgage insurance companies to cover any losses experienced in the portion ceded to us. The amounts we maintain are determined periodically by these companies and reflect the difference between their estimated future unearned premiums and their overall assessment at the time of our probability of maximum loss related to our ceded portion and the related severity of such loss.

During 2009, FRC executed commutation agreements with three of the four mortgage insurance companies it had reinsurance agreements with. Under each commutation agreement, the respective mortgage insurance company took back the ceded risk (thereby again assuming the entire insured risk) and receives 100% of the premiums. In addition, the mortgage insurance company received all the cash held in trust, less the amount in excess of the projected amount of the future liability. At December 31, 2009, FRC s maximum exposure related to the remaining reinsurance agreement amounted to $18.0 million. Pursuant to the agreements, we are not obliged to provide any funds to the mortgage insurance companies to cover any losses in our ceded portion other than the funds we are required to maintain in these separately managed accounts. Although FRC s obligation is subordinated to the primary insurer, we believe that FRC s risk of loss is limited to the amount of the managed account. At December 31, 2009, this account had a balance totaling $15.6 million, as to which the majority had already been reserved. As of December 31, 2009,

$0.7 million in claims had been made against FRC on the mortgage loan credit enhancement it provided.

Paperless Office Solutions, Inc. Paperless Office Solutions, Inc. (POS), a wholly-owned subsidiary of ours, provides online paperless office solutions for mortgage originators. DocVelocity is the flagship product developed by POS to bring web-based paperless mortgage processing to mortgage originators.

Other Flagstar Subsidiaries. In addition to the Bank, Douglas, FRC and POS, we have a number of wholly-owned subsidiaries that are inactive. We also own ten statutory trusts that are not consolidated with our operations. For additional information, see Notes 3 and 18 of the Notes to the Consolidated Financial Statements, in Item 8. Financial Statements and Supplementary Data, herein.

Flagstar Bank. The Bank, our primary subsidiary, is a federally chartered, stock savings bank headquartered in Troy, Michigan. The Bank is also the sole stockholder of FCMC.

Flagstar Capital Markets Corporation. FCMC is a wholly-owned subsidiary of the Bank and its functions include holding investment loans, purchasing securities, selling and securitizing mortgage loans, maintaining and selling mortgage servicing rights, developing new loan products, establishing pricing for mortgage loans to be acquired, providing for lock-in support, and managing interest rate risk associated with these activities.

Flagstar ABS LLC. Flagstar ABS LLC is a wholly-owned subsidiary of FCMC that serves as a bankruptcy remote special purpose entity that has been created to hold trust certificates in connection with our private securitization offerings.

Other Bank Subsidiaries. The Bank, in addition to FCMC, also wholly-owns several other subsidiaries, all of which were inactive at December 31, 2009.

Regulation and Supervision

Both the Company and the Bank are subject to regulation by the OTS, and the Bank is also subject to regulation by the FDIC. The Bank is a member of the FHLBI and its deposits are insured by the FDIC through the DIF. Accordingly, it is subject to an extensive regulatory framework which imposes activity restrictions, minimum capital requirements, lending and deposit restrictions and numerous other requirements primarily intended for the protection of depositors, the federal deposit insurance fund and the banking system as a whole, rather than for the protection of stockholders and creditors. Many of these laws and regulations have undergone significant changes in recent years and are likely to change in the future. Future legislative or regulatory change, or changes in enforcement practices or court rulings, may have a significant and potentially adverse impact on our operations and financial condition. Our non-bank financial subsidiaries are also subject to various federal and state laws and regulations.

Supervisory Agreements. On January 27, 2010, we and the Bank entered into the Supervisory Agreements. We and the Bank have taken numerous steps to comply with, and intend to comply in the future with, all of the requirements of the Supervisory Agreements, and do not believe that the Supervisory Agreements will materially constrain management s ability to implement the business plan. The Supervisory Agreements will remain in effect until terminated, modified, or suspended in writing by the OTS, and the failure to comply with the Supervisory Agreements could result in the initiation of further enforcement action by the OTS, including the imposition of further operating restrictions and result in additional enforcement actions against us.

Bank Supervisory Agreement. Pursuant to the Bank Supervisory Agreement, the Bank agreed to take certain actions to address certain banking issues identified by the OTS. The Bank Supervisory Agreement requires the Bank to, among other things, prepare a new business plan which the Bank has done. This business plan has been reviewed by the OTS without objection. The business plan addresses other actions required by the Bank Supervisory Agreement, including a plan to reduce the level of certain classified assets, the adoption of revised loan administration policies and

procedures, implementation of a liquidity risk management program, the furtherance of asset concentration limits, attention to certain market risk exposure and mortgage servicing rights issues, and the establishment of a new written consumer compliance program. In addition, the business plan provides targets for asset size. Under the Bank Supervisory Agreement, the Bank must receive OTS approval of dividends or other capital distributions, not make certain severance or indemnification payments, notify the OTS of changes in directors or senior executive officers, provide notice of new, renewed,

extended or revised contractual arrangements relating to compensation or benefits for any senior executive officer or directors, receive consent to increase salaries, bonuses or director s fees for directors or senior executive officers, and receive OTS non-objection of certain third party arrangements.

Bancorp Supervisory Agreement. Pursuant to the Bancorp Supervisory Agreement, Bancorp is required to, among other things, submit a capital plan to the OTS, receive OTS non-objection of paying dividends, other capital distributions or purchases, repurchases or redemptions of certain securities, of incurrence, issuance, renewal, rolling over or increase of any debt and of certain affiliate transactions, and comply with similar restrictions on the payment of severance and indemnification payments, prior OTS approval of directorate and management changes and prior OTS approval of employment contracts and compensation arrangements applicable to the Bank.

Holding Company Status and Acquisitions. We are a savings and loan holding company, as defined by federal banking law, as is our controlling stockholder, MP Thrift. Neither we nor MP Thrift may acquire control of another savings association unless the OTS approves such transaction and we may not be acquired by a company other than a bank holding company unless the OTS approves such transaction, or by an individual unless the OTS does not object after receiving notice. We may not be acquired by a bank holding company unless the Board of Governors of the Federal Reserve System (the Federal Reserve) approves such transaction. In any case, the public must have an opportunity to comment on any such proposed acquisition and the OTS or Federal Reserve must complete an application review. Without prior approval from the OTS, we may not acquire more than 5% of the voting stock of any savings institution. In addition, the Gramm-Leach-Bliley Act generally restricts any non-financial entity from acquiring us unless such non-financial entity was, or had submitted an application to become, a savings and loan holding company on or before May 4, 1999. Also, because we were a savings and loan holding company prior to that date, we may engage in non-financial activities and acquire non-financial subsidiaries.

Source of Strength. We are required to act as a source of strength to the Bank and to commit managerial assistance and capital to support the Bank. The required support may be needed at times when we may not find ourselves able to provide it. Capital loans by a savings and loan holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of the bank. In the event of a savings and loan holding company s bankruptcy, any commitment by the savings and loan holding company to a federal bank regulator to maintain the capital of a subsidiary bank should be assumed by the bankruptcy trustee and may be entitled to a priority of payment.

Standards for Safety and Soundness. Federal law requires each U.S. banking agency to prescribe certain standards for all insured depository institutions. The U.S. banking agencies adopted Interagency Guidelines Establishing Standards for Safety and Soundness to implement the safety and soundness standards required under federal law. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. If the appropriate U.S. banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet the standard, the appropriate U.S. banking agency may require the institution to submit a compliance plan.

Capital Adequacy. The Bank must maintain a minimum amount of capital to satisfy various regulatory capital requirements under OTS regulations and federal law. There is no such requirement that applies to us, although we are required to provide a capital plan to the OTS pursuant to the Bancorp Supervisory Agreement. Federal law and regulations establish five levels of capital compliance: well-capitalized, adequately-capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Effective January 27, 2010, the Bank received

$300.0 million in capital from us following the simultaneous investment in us the same day by MP Thrift pursuant to the rights offering. On February 8, 2010, the Bank received $0.6 million in additional capital from us following the closing of the rights offering. At December 31, 2009, the Bank had regulatory

capital ratios of 6.19% for Tier 1 capital and 11.68% for total risk-based capital. Had the Bank received the $300.6 million at December 31, 2009, the Bank s regulatory capital ratios would have been 8.16% for Tier 1 capital and 15.28% for total risk-based capital. An institution is treated as well-capitalized if its ratio of total risk-based capital to risk-weighted assets is 10.0% or more, its ratio of Tier 1 capital to risk-weighted assets is 6.0% or more, its leverage ratio (also referred to as its core capital ratio) is 5.0% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In contrast, an institution is only considered to be adequately-capitalized if its capital structure satisfies lesser required levels, such as a total risk-based capital ratio of not less than 8.0%, a Tier 1 risk-based capital ratio of not less than 4.0%, and (unless it is in the most highly-rated category) a leverage ratio of not less than 4.0%. Any institution that is neither well capitalized nor adequately-capitalized will be considered undercapitalized. Any institution with a tangible equity ratio of 2.0% or less will be considered critically undercapitalized.

On November 1, 2007, the OTS and the other U.S. banking agencies issued final regulations implementing the new risk-based regulatory capital framework developed by The Basel Committee on Banking Supervision, which is a working committee established by the central bank governors of certain industrialized nations, including the United States. The new risk-based regulatory capital framework, commonly referred to as Basel II, includes several methodologies for determining risk-based capital requirements, and the U.S. banking agencies have so far only adopted methodology known as the advanced approach. The implementation of the advanced approach is mandatory for the largest U.S. banks and optional for other U.S. banks.

For those other U.S. banks, the U.S. banking agencies had issued advance rulemaking notices through December 2006 that contemplated possible modifications to the risk-based capital framework applicable to those domestic banking organizations that would not be affected by Basel II. These possible modifications, known colloquially as Basel 1A, were intended to avoid future competitive inequalities between Basel I and Basel II organizations. However, the U.S. banking agencies withdrew the proposed Basel 1A capital framework in late 2007. In July 2008, the agencies issued the proposed rule that would give banking organizations that do not use the advanced approaches the option to implement a new risk-based capital framework. This framework would adopt the standardized approach of Basel II for credit risk, the basic indicator approach of Basel II for operational risk, and related disclosure requirements. While this proposed rule generally parallels the relevant approaches under Basel II, it diverges where United States markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. While comments on the proposed rule were due to the agencies by October 27, 2008, a definitive final rule has not been issued. The proposed rule, if adopted, would replace the agencies earlier proposed amendments to existing risk-based capital guidelines to make them more risk sensitive. The proposed rule, if adopted, would replace the agencies earlier proposed amendments to existing risk-based capital guidelines to make them more risk sensitive (formerly referred to as the Basel I-A approach).

On September 3, 2009, Treasury issued a policy statement (the Treasury Policy Statement) entitled Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms. The Treasury Policy Statement was developed in consultation with the U.S. banking agencies and contemplates changes to the existing regulatory capital regime that would involve substantial revisions to, if not replacement of, major parts of the Basel I and Basel II capital frameworks and affect all regulated banking organizations and other systemically important institutions. The Treasury Policy Statement calls for, among other things, higher and stronger capital requirements for all banking firms and suggested that changes to the regulatory capital framework be phased in over a period of several years. The recommended schedule provides for a comprehensive international agreement by December 31, 2010, with the implementation of reforms effective December 31, 2012, although it does remain possible that U.S. bank regulatory agencies could officially adopt, or informally implement, new capital standards at an earlier date.

On December 17, 2009, the Basel Committee issued a set of proposals (the Capital Proposals) that would significantly revise the definitions of Tier 1 capital and Tier 2 capital, with the most significant changes being to Tier 1 capital.

Most notably, the Capital Proposals would disqualify certain structured capital instruments, such as trust preferred securities, from Tier 1 capital status. The Capital Proposals would also re-emphasize that common equity is the predominant component of Tier 1 capital by adding a minimum common equity to risk-weighted assets ratio and requiring that goodwill, general intangibles and certain other items that

currently must be deducted from Tier 1 capital instead be deducted from common equity as a component of Tier 1 capital. The Capital Proposals also leave open the possibility that the Basel Committee will recommend changes to the minimum Tier 1 capital and total capital ratios of 4.0% and 8.0%, respectively.

Concurrent with the release of the Capital Proposals, the Basel Committee also released a set of proposals related to liquidity risk exposure (the Liquidity Proposals, and together with the Capital Proposals, the 2009 Basel Committee Proposals). The Liquidity Proposals have three key elements, including the implementation of (i) a liquidity coverage ratio designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets sufficient to meet the bank s liquidity needs over a 30-day time horizon under an acute liquidity stress scenario, (ii) a net stable funding ratio designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon, and (iii) a set of monitoring tools that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors and that supervisors should use in monitoring the liquidity risk profiles of supervised entities.

Comments on the 2009 Basel Committee Proposals are due by April 16, 2010, with the expectation that the Basel Committee will release a comprehensive set of proposals by December 31, 2010 and that final provisions will be implemented by December 31, 2012. The U.S. bank regulators have urged comment on the 2009 Basel Committee Proposals. Ultimate implementation of such proposals in the U.S. will be subject to the discretion of the U.S. bank regulators and the regulations or guidelines adopted by such agencies may, of course, differ from the 2009 Basel Committee Proposals and other proposals that the Basel Committee may promulgate in the future.

Qualified Thrift Lender. The Bank is required to meet a qualified thrift lender (QTL) test to avoid certain restrictions on our operations, including the activities restrictions applicable to multiple savings and loan holding companies, restrictions on our ability to branch interstate and the Company s mandatory registration as a bank holding company under the Bank Holding Company Act of 1956. A savings association satisfies the QTL test if: (i) on a monthly average basis, for at least nine months out of each twelve month period, at least 65% of a specified asset base of the savings association consists of loans to small businesses, credit card loans, educational loans, or certain assets related to domestic residential real estate, including residential mortgage loans and mortgage securities; or (ii) at least 60% of the savings association s total assets consist of cash, U.S. government or government agency debt or equity securities, fixed assets, or loans secured by deposits, real property used for residential, educational, church, welfare, or health purposes, or real property in certain urban renewal areas. The Bank is currently, and expects to remain, in compliance with QTL standards.

Payment of Dividends. We are a legal entity separate and distinct from the Bank and our non-banking subsidiaries. In 2008, we discontinued the payment of dividends on our common stock. Moreover, we are prohibited from increasing dividends on our common stock above $0.05 per share without the consent of the Treasury pursuant to the terms of the TARP Capital Purchase Program and from making dividend payments on our stock except pursuant to the prior non-objection of the OTS as set forth in the Bancorp Supervisory Agreement. Our principal sources of funds are cash dividends paid by the Bank and other subsidiaries, investment income and borrowings. Federal laws and regulations limit the amount of dividends or other capital distributions that the Bank may pay us. The Bank has an internal policy to remain well-capitalized under OTS capital adequacy regulations (discussed immediately above). The Bank does not currently expect to pay dividends to us and, even if it determined to do so, would not make payments if the Bank were not well-capitalized at the time or if such payment would result in the Bank not being well-capitalized. In addition, the Bank must seek prior approval from the OTS at least 30 days before it may make a dividend payment or other capital distribution to us.

Troubled Asset Relief Program. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (initially introduced as the Troubled Asset Relief Program or TARP) was enacted. On October 14, 2008, the Treasury announced its intention to inject capital into nine large U.S. financial institutions under the TARP, and since has

injected capital into many other financial institutions. On January 30, 2009, we entered into a letter agreement including the securities purchase agreement with the Treasury pursuant to which,

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among other things, we sold to the Treasury preferred stock and warrants. Under the terms of the TARP, we are prohibited from increasing dividends on our common stock above $0.05 per share, and from making certain repurchases of equity securities, including our common stock, without the Treasury s consent. Furthermore, as long as the preferred stock issued to the Treasury is outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including our common stock, are prohibited until all accrued and unpaid dividends are paid on such preferred stock, subject to certain limited exceptions.

American Recovery and Reinvestment Act of 2009. On February 17, 2009, the U.S. President signed into law the American Recovery and Reinvestment Act of 2009 (ARRA), more commonly known as the economic stimulus or economic recovery package. ARRA includes a wide variety of programs intended to stimulate the economy and provide for extensive infrastructure, energy, health, and education needs. In addition, ARRA imposes certain new executive compensation and corporate expenditure limits on all current and future TARP recipients that are in addition to those previously announced by the Treasury, until the institution has repaid the Treasury, which is now permitted under ARRA without penalty and without the need to raise new capital, subject to the Treasury s consultation with the recipient s appropriate regulatory agency.

Homeowner Affordability and Stability Plan. On February 18, 2009, the Homeowner Affordability and Stability Plan (HASP) was announced by the U.S. President. HASP is intended to support a recovery in the housing market and ensure that workers can continue to pay off their mortgages by providing access to low-cost refinancing for responsible homeowners suffering from falling home prices, implementing a $75 billion homeowner stability initiative to prevent foreclosure and help responsible families stay in their homes, and supporting low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac. We continue to monitor these developments and assess their potential impact on our business and the Bank.

FDIC Assessment. The FDIC insures the deposits of the Bank and such insurance is backed by the full faith and credit of the United States government through the DIF. Under FDIC guidelines issued in November 2006, the Bank s premiums increased to increase the capitalization of the DIF. For 2009, the assessment was approximately $36.6 million, before any credits, as compared to $7.9 million in 2008. The increase for 2009 reflects, in part, a special five basis point assessment during the third quarter 2009, generally based on an institution s total deposits outstanding at June 30, 2009, to compensate for an unexpected and significant decline in the DIF.

FDIC Temporary Liquidity Guarantee Program. The FDIC s Temporary Liquidity Guarantee Program (TLGP) was created in 2008 to provide banks with the opportunity to participate in a debt guarantee program or a transaction account guarantee program. Under the debt guarantee component of the TLGP, the FDIC will pay the unpaid principal and interest on an FDIC-guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest in accordance with the terms of the instrument. Under the transaction account guarantee component of the TLGP, all noninterest-bearing transaction accounts at a participating bank are insured in full by the FDIC until June 30, 2010 (extended from December 31, 2009, subject to an opt-out provision, by subsequent amendment) regardless of the standard maximum deposit insurance amount. The Bank elected to participate only in the transaction account guarantee program.

Affiliate Transaction Restrictions. The Bank is subject to the affiliate and insider transaction rules applicable to member banks of the Federal Reserve as well as additional limitations imposed by the OTS. These provisions prohibit or limit a banking institution from extending credit to, or entering into certain transactions with, affiliates, principal stockholders, directors and executive officers of the banking institution and its affiliates.

Federal Reserve. Numerous regulations promulgated by the Federal Reserve affect the business operations of the Bank. These include regulations relating to equal credit opportunity, electronic fund transfers, collection of checks, truth in lending, truth in savings and availability of funds.

Under Federal Reserve regulations, the Bank is required to maintain a reserve against its transaction accounts (primarily interest-bearing and non-interest-bearing checking accounts). These reserves must

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generally be maintained in cash or in non-interest-bearing accounts, and therefore an effect of the reserve requirement is to increase the Bank s cost of funds.

Patriot Act. The USA PATRIOT Act, which was enacted following the events of September 11, 2001, includes numerous provisions designed to detect and prevent international money laundering and to block terrorist access to the U.S. financial system. We have established policies and procedures intended to fully comply with the USA PATRIOT Act s provisions, as well as other aspects of anti-money laundering legislation and the Bank Secrecy Act.

Consumer Protection Laws and Regulations. Examination and enforcement by bank regulatory agencies for non-compliance with consumer protection laws and their implementing regulations have become more intense. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below.

Federal regulations require additional disclosures and consumer protections to borrowers for certain lending practices, including predatory lending. The term predatory lending, much like the terms safety and soundness and unfair and deceptive practices, is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. Predatory lending typically involves at least one, and perhaps all three, of the following elements:

- Making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation (asset-based lending);
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (loan flipping); and/or
- Engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Many states also have predatory lending laws, and although the Bank is typically exempt from those laws due to federal preemption, they do apply to the brokers and correspondents from whom we purchase loans and, therefore have an effect on our business and our sales of certain loans into the secondary market.

The Gramm-Leach-Bliley Act includes provisions that protect consumers from the unauthorized transfer and use of their non-public personal information by financial institutions. Privacy policies are required by federal banking regulations which limit the ability of banks and other financial institutions to disclose non-public personal information about consumers to nonaffiliated third parties. Pursuant to those rules, financial institutions must provide:

- Initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- Annual notices of their privacy policies to current customers; and
- A reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

These privacy protections affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. In addition, states are permitted under the Gramm-Leach-Bliley Act to have their own privacy laws, which may offer greater protection to consumers than the Gramm-Leach-Bliley Act. Numerous states in which we do business have enacted such laws.

The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, or FACT Act, requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and gives consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with the FACT Act, financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer s election to opt out would be applicable for at least five years.

The Equal Credit Opportunity Act, or ECOA, generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act, or TILA, is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The Fair Housing Act, or FH Act, regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered illegal, under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The Home Mortgage Disclosure Act, or HMDA, grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a fair lending aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes. In 2004, the Federal Reserve Board amended regulations issued under HMDA to require the reporting of certain pricing data with respect to higher-priced mortgage loans. This expanded reporting is being reviewed by federal banking agencies and others from a fair lending perspective.

The Real Estate Settlement Procedures Act, or RESPA, requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts. Violations of RESPA may result in civil liability or administrative sanctions. Regulation X which implements RESPA has been completely amended to simplify and improve the disclosure requirements for mortgage settlement costs and to make the mortgage process easier to understand for consumers and to encourage consumers to compare mortgage loans from various lenders before making a decision on a particular loan. Most of the required disclosures have been revised, and new disclosures, procedures and restrictions have been added.

Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with the FACT Act, ECOA, TILA, FH Act, HMDA and RESPA generally, the Bank may incur additional compliance costs or be required to expend additional funds for investments in its local community.

Community Reinvestment Act. The Community Reinvestment Act (CRA) requires the Bank to ascertain and help meet the credit needs of the communities it serves, including low- to moderate-income neighborhoods, while maintaining safe and sound banking practices. The primary federal regulatory agency assigns one of four possible ratings to an institution s CRA performance and is required to make public an institution s rating and written evaluation. The four possible ratings of meeting community credit needs are outstanding, satisfactory, needs to improve and substantial noncompliance. In 2009, the Bank received a satisfactory CRA rating from the OTS.

Office of Foreign Assets Control Regulation. The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the OFAC rules based on their administration by the Treasury Office of Foreign Assets Control (OFAC). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the

following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on U.S. persons engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in

which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences.

Regulatory Reform. In June 2009, President Obama proposed a wide range of regulatory reforms that, if enacted, may have significant effects on the financial services industry in the United States. Significant aspects of these proposals that may affect us include, among other things, proposals: (i) to reassess and increase capital requirements for banks and bank holding companies and examine the types of instruments that qualify as regulatory capital; (ii) to combine the Office of the Comptroller of the Currency and the OTS into a National Bank Supervisor with a unified federal bank charter; (iii) to create a federal consumer financial protection agency to be the primary federal consumer protection supervisor with broad examination, supervision and enforcement authority with respect to consumer financial products and services; (iv) to further limit the ability of financial institutions to engage transactions with affiliates; and (v) to subject all over-the-counter derivatives markets to comprehensive regulation.

The U.S. Congress, state lawmaking bodies and federal and state regulatory agencies continue to consider a number of wide-ranging and comprehensive proposals for altering the structure, regulation and competitive relationships of the nation s financial institutions, including rules and regulations related to the administration s proposals. Separate comprehensive financial reform bills intended to address the proposals set forth by the administration were introduced in both houses of Congress in the second half of 2009 and remain under review by both the U.S. House of Representatives and the U.S. Senate. In addition, both the Treasury and the Basel Committee have issued policy statements regarding proposed significant changes to the regulatory capital framework applicable to banking organizations as discussed above. We cannot predict whether or in what form further legislation or regulations may be adopted or the extent to which we may be affected thereby.