FINAL TRANSCRIPT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CapitalSource first-quarter 2008 earnings conference call. My name is Karen and I will be your coordinator for today. At this time, all participants are in listen-only mode. We will be facilitating a question-and-answer session towards the end of this conference. (OPERATOR INSTRUCTIONS) As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Mr. Dennis Oakes, Vice President, Investor Relations.

Dennis Oakes - *CapitalSource, Inc. - VP-IR*

Thank you, Karen. Good morning, everyone, and thank you for joining us for the CapitalSource first-quarter 2008 earnings conference call. Joining me today are John Delaney, our Chairman and CEO, and Tom Fink, our Chief Financial Officer.

This call is being webcast live on our website and a recording of the call be available beginning at approximately 10:30 AM Eastern time today. Our earnings press release and website provide details on accessing the archived call.

Investors are urged to read the forward-looking statements language in our earnings release, but essentially it says statements made on this earnings call which are not historical facts may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All forward-looking statements, including statements regarding future financial operating results, dividends, transactions involving risks, uncertainties, and contingencies, many of which are beyond the control of CapitalSource and which may cause actual results to differ materially from anticipated results.

CapitalSource is under no obligation to update or alter our forward-looking statements, whether as a result of new information, future events, or otherwise, and we expressly disclaim any obligation to do so. More detailed information about the risk factors can be found in our press release issued this morning and in our reports filed with the SEC.

I will turn the call over now to John Delaney.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Thanks, Dennis, and good morning, everyone. We were very pleased with the Company's performance on a number of fronts this quarter. First, credit continued to be strong, with non-accruals and delinquencies essentially flat from the prior quarter.

We are obviously very mindful of the economic environment that we are in and the effect that it can have on credit, but thus far, we have not experienced any material reduction in credit performance. I attribute this to sound lending, good underwriting, and a diversified book of business.

Second, I was actually very pleased with the adjusted earnings performance of the business at $0.51 per share for the quarter, particularly since we recognized $0.09 in quarterly adjusted earnings loss related to the reduction of our agency portfolio by over $600 million. We have continued to reduce our agency portfolio and today it stands at about $1.6 billion, down from peak of about $4 billion. The reason for this reduction is simple. We did not need as many agencies for REIT compliance and we elected to reduce the portfolio, not because we had to, but simply because we could and it results in a dramatic reduction in any funding risk against this portfolio.

Third, margin improved by almost 100 basis points, reflecting both the work the portfolio team has done in passing on our higher cost of funds to our existing borrowers when we can, and the benefits of interest rate floors, which I think many of you know is a feature of our lending practices. Both of these actions, increasing spreads to existing borrowers and interest rate floors, are just more examples of the benefit of a direct origination and active portfolio management model that we have here at CapitalSource.

Our proposed acquisition of certain assets and branches of Fremont Investment & Loan is on track in all material respects. In fact, we filed our regulatory applications last week. Only a few weeks ago, we spoke in some detail as to the various reasons we view this acquisition as attractive. We plan on providing you with more specific details as to how this acquisition will integrate with our business and the effects it will have on the key drivers of our business model, such as originations, profitability, and capital utilization.

It is our current plan to provide new guidance in August, probably with our second-quarter earnings announcement, that will reflect this acquisition.

The general operating environment in the credit markets has stabilized, but that is not to say that we are at a point where such stabilization is anything close to what I would consider normal. Credit markets remain virtually closed for new-issue securitizations or large loans. While deals that are very conservatively structured can likely get done, and we were gearing up for one prior to the bank deal being announced, the terms are not attractive.

We've seen some stabilization in spreads and secondary loan prices, but again, at levels that are far wider in the case of spreads or lower in the case of loan prices than anyone ever imagined. As a result, the environment for new loans remains very attractive, with an utter lack of competition existing in most of our end markets. We expect a limited number of new entrants to start filling this void, much less than some anticipate, to my mind, because the funding model for new entrants will remain, in my judgment, impaired for years to come. And I'm not sure how some of these new entrants will secure debt capital to fund their business.

Let me sum up by saying we feel very good about the direction of the Company. Credit and asset quality is once again strong. We have reduced our exposure dramatically to agencies; that issue should now be off the table. And the funding environment for us is improving. Regarding our dividend for second quarter, we anticipate declaring a $0.60 dividend towards the end of this month. Tom?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Thank you, John. I concur with the assessment that our results this quarter were very good, from both the perspective of credit and our financial performance, especially I would say considering the state of the capital markets.

In addition to the things that John mentioned, a focus of ours during the quarter has been the renewal of our secured credit facilities, on which we have made significant progress. As of this date, we have renewed two credit facilities totaling $1.2 billion of committed financing, and we are working to complete the early renewal of two additional credit facilities.

The first two facilities that renewed at the end of last month had renewal dates in April of 2008. So these have been renewed in the normal course. The other two facilities, which we expect to close soon, have renewal dates coming up across the next few months, but we decided to begin the renewal process early so as to remove this uncertainty from our funding picture.

As expected, the terms of these credit facility renewals reflect market conditions, including higher pricing and lower advance rates. Also, the commitment levels have been adjusted to lower levels. The lower commitment levels make sense for us given the lower level of originations we are currently seeing and expect to see prior to the closing of the bank transaction, as well as the higher fees that the banks are now charging for unused commitments.

With respect to our commercial finance business, one of the things we saw this quarter was a significant and rapid drop in short-term interest rate indices such as Prime and LIBOR. As a result, we had both lower yield and lower cost of funds in the first quarter compared to the prior quarter.

What I want to tell you is that the net of these two has been positive in terms of the credit spread that we charge to our borrowers.

As John highlighted in his remarks, during the quarter, we saw an improved core lending spread relative to our 30-day LIBOR benchmark. The core yield of our portfolio -- that is, yield excluding any prepayment-related fee income -- was 10.42% this quarter. Subtracting out the 30-day LIBOR average for the quarter of 3.3%, you arrive at our core lending spread of 7.12%. This core lending spread was 99 basis points higher than our Commercial Finance core lending spread of the prior quarter, and we are very pleased with that performance.

On the funding side, we saw lower cost of funds in the quarter but an increase in the borrowing spread to average LIBOR. The borrowing spread to LIBOR was 2.15%, or 62 basis points higher than last quarter, due to the continued volatility in the short-term funding markets. But a simple comparison of these two spread numbers shows that our net core lending spread -- that is, our core lending spread minus our borrowing spread -- increased by 37 basis points compared to last quarter.

A final item that I'd like to touch on before wrapping up is operating expenses, which has been a focus of ours. In dollar terms, total operating expenses for the quarter were down approximately $3.6 million compared to the fourth quarter, principally due to a reduction in compensation and benefits expense, offset by an increase in professional fees. During the first quarter, we

wrote off approximately $4 million in expenses related to the TierOne acquisition, which was terminated in March, and that amount is included in the operating expense this quarter.

In terms of a percentage of assets, operating expense in our Commercial Finance segment was 2.03% in the quarter compared to 2.2% in the prior quarter. On a consolidated basis, our operating expenses, excluding depreciation on direct real estate investments, as a percentage of assets was 1.31% for the quarter, down from 1.38% last quarter.

And with that, we will to call back to Dennis Oakes.

Dennis Oakes - *CapitalSource, Inc. - VP-IR*

Thank you. Karen, we're ready for the first question now. We would ask questioners just to limit themselves to one question and one follow-up so we can get to as many callers as possible.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Robert Napoli, Piper Jaffray.

Robert Napoli - *Piper Jaffray - Analyst*

Good morning. Nice job in a pretty tough environment. Congratulations on that.

John, credit quality looks very good, and I just wondered what you are seeing in the economy and what is your outlook for credit. We would expect that, given what we're seeing in the economy broadly, that we would expect to see credit losses move up through this year. I was wondering if you could give a little bit of color on that. And just one follow-up then.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Sure, Bob. As I said in my remarks, credit has -- and as you highlighted -- has remained very strong for us, with no real deterioration in our credit metrics. However, as you're highlighting as well, we are mindful of what is going on in the real world, where there is dramatic upheaval in the credit markets and there is clear signs of reduced consumer spending, recessionary talks, whether we are technically there or not, is all stuff that we are fairly mindful of.

We're seeing some signs of that in the portfolio, kind of what I'll call around the edges. It's not something that is concerning us kind of in the core of the business. And I think our approach to credit is reflective of what's going on the general world, which is we are cautious. I think it is reasonable to assume that there will be pressure on credit at all financial institutions. We've obviously seen it in residential credit dramatically, but in other aspects as well.

But thus far, knock wood, we are hanging in there very well. And again, I think it's due to basic kind of sound lending, which is underwriting your loans carefully, making sure of your senior lender, doing your loan-to-value work well, structuring your loans appropriately and managing the credits in a tight and proactive fashion. If you do all those things, even in a tough credit requirement, your credit outcomes should not be that bad. And that is really our approach to the business.

Robert Napoli - *Piper Jaffray - Analyst*

Okay. As far as the growth of the business, I would expect also in this environment -- while there's -- you could probably put on a lot of business at great rates, with the funding markets the way they are, wouldn't expect to see much growth through the next several quarters, couple quarters anyway. I just wondered if you could talk about that growth and then the downsizing -- some downsizing in the employee base. Is that primarily in the origination side?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

I would say -- two questions there. There hasn't really been any kind of systematic downsizing in the employee base. Obviously, in these kinds of environments we have a very critical eye towards what parts of the Company are making us money and what parts are not achieving our ROE standards. And everyone, I think, becomes more disciplined in these environments in all aspects of their business, including operating expenses, as we have been.

In terms of originations, there are very good opportunities in the market. There has really been -- the new lending environment has really been frozen for awhile because the transaction volume is down quite a bit. There's a lot of opportunities in the secondary markets, obviously. But we think the opportunities are good.

We have been very prudent about deploying new capital, and we started this posture way back in August of '07, if you recall, based on our view of what was happening and where it would settle in at. And I still don't feel a real rush to put money to work right now, because I think opportunities, even if they don't get better, I don't think that we are going to miss an opportunity in the short-term. In other words, I think the environment we're in now will last for some period of time.

And we're obviously very focused on our new depository, which will improve our access to all forms of capital. And we think that's going to be a terrific opportunity for us to deploy our balance sheet and grow our balance sheet in a prudent way.

So I think we have been managing our liquidity very carefully, making sure the business is kind of flush with liquidity. We've actually delevered the business across last six months. We think we're in a very good liquidity position to take advantage of what will be a sustained lending opportunity and that the depository will only enhance that.

Robert Napoli - *Piper Jaffray - Analyst*

Thank you.

Operator

John HECHT, JMP Securities.

John Hecht - *JMP Securities - Analyst*

Good morning, thanks for taking my questions. Tom, you mentioned you were addressing two of your facilities early over the next couple of months. Can you tell us beyond that what your requirements are going to be to address your financing for the remaining part of 2008?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Well, I think -- first of all, those facilities have renewal or other dates that come up within the next several months, but we are actively working on them now to renew them early and expect to complete that shortly.

I would say after that, those are the major milestones that we had to achieve with respect to our funding plan for the year. And that really kind of clears the decks for us to focus, as John said, on the depository, closing on our new bank and acquiring the Fremont branches, deposits, etc.

John Hecht - *JMP Securities - Analyst*

Okay. Then with respect to the net finance margin, you guys did experience -- I think was it five basis points of contraction this quarter -- although if my data is right, it looks like that was the least amount of contraction relative to the last several quarters. So given that you are rolling your financing and you may pick up some deposits, and it's possible that the Fed is done here in terms of interest rate reductions, should we start -- is it kind of your belief in the near term that we should start seeing stabilization and potential increases in net finance margins?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Yes, I think the contraction in net finance margin is driven by a number of factors, one of which is just the absolute level of rates, because we do have more assets than liabilities and have a relatively low level of leverage in the business. So lower short-term rate environment would and has reduced the net finance margin.

The things that I focus on are really our spreads relative to these short-term markets. And that is why I spoke in my remarks earlier about our core lending spread and that borrowing spread as well. And the point that I am highlighting here is that the core lending spread increased and it increased more than the borrowing spread did, which we are very pleased about.

And John referenced actions that we're taking in the portfolio, where we can, to pass on higher costs to our borrowers. Also, we have the beneficial effect of floors in the loans, etc., contributing to that increased spread on the lending side. So that is positive.

The things that have been driving the increased borrowing spread, certainly in the first quarter and the second quarter of this year, first and foremost, it is due to the volatility in the short-term funding markets. In the first quarter, you saw LIBOR decrease 160 basis points on average. And with these credit facilities and things that we have, it's just very hard for those facilities to instantly reduce their cost of funding. So there is a bit of a lag effect.

So as we go through 2008, particularly, as you referenced, with the Fed perhaps being perhaps done with their efforts, we should see that bit of noise in the cost of funding disappear. That will be replaced by higher cost of funds. So I would expect to see certainly some stability in our cost of funds, our borrowing spread relative to LIBOR, but that this increased lending spread will continue.

John Hecht - *JMP Securities - Analyst*

Okay, thanks very much.

Operator

Sameer Gokhale, KBW.

Sameer Gokhale - *KBW - Analyst*

Hi, good morning. I just had a couple of quick ones. The other expense number net was -- showed, I guess, an expense of $4.7 million this quarter, compared to $4.3 million of income last quarter. And I know you have some foreign currency losses in there,

but if you exclude the items that you back out to get to adjusted earnings, what would be kind of the relative comps last quarter to this quarter? I just want to get a breakout of those items if possible.

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

You're right -- we do have some foreign currency items. We have some foreign currency loans in a European subsidiary, which is our office in London. So we do get hung up with some foreign currency translation issues between euro-denominated loans and our US-dollar-denominated balance sheet and income statement here.

You know, looking at the other items that are in there, that explains a big part of the swing. We have a few items that resulted in gains in other income. We had a similar amount, I would say, in the last quarter. So it's really that foreign currency item that explains the swing there.

Sameer Gokhale - *KBW - Analyst*

Okay. Maybe I will follow up with some questions later on. The other thing I was wondering was on the impaired loans, your current metrics obviously are very stable. But the one category where there was a little bit of an increase was in the impaired loans. Can you talk a little bit about the loans that went into that bucket? Were those new loans or was it just some denominator effect in the ratio that's driving that ratio up? Can you just talk about that a little bit, please?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Sure, Sameer. This is John and I will let Tom answer --but one thing to remember on that category is that includes these things that are definitionally impaired, which is more of an accounting convention, and doesn't really get to the heart of the matter on the loan. So I can say that the uptick in that category was entirely due to that, related to loans that we don't think are problem loans, but under the accounting definition, they have to be characterized as impaired. Tom, I'm not sure --

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Tom Fink - *CapitalSource, Inc. - SVP, CFO*

I think that's exactly right, John. That is why we, in all of our conversations, try to focus on the non-accruals as being the most important measure, because that impaired asset number does pick up and includes a fair amount of these definitionally impaired loans. And just to review what that is, that may be a loan that we consider to be credit good, but is beyond its scheduled maturity, for example, or otherwise not going to be paid in accordance with its contractual terms. It does not mean we're not going to ultimately get paid. And that is the big driver of the change in impaired assets this quarter.

So for all those reasons in our non-accruals, it is really the most important metric. And just to expand on what John said about the credit metrics, we have been at the lower ends of these historical ranges here for several quarters now. So we are obviously very pleased with the credit performance of the business.

Sameer Gokhale - *KBW - Analyst*

Okay. Just quick one last one, if I may, on the structured finance business, it seems like this is an environment, particularly if you look at the rediscount business, where there could be a lot of opportunities for you. I know you give us some commentary on the funding side and what's happened to costs and the structure, the securitizations aren't that attractive.

But is the idea essentially that you renewed these new warehouse facilities and then in your, say, rediscount business you may have borrowers that you can lend to at very, very safe structures for you as a company, and that is when you kind of ramp up,

is when you just have some of these new facilities in place. Is that how you are viewing this sort of environment from growth standpoint? Specifically, if you say look at that rediscount business.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

I think that is a very good kind of assessment or a good way of framing the whole business picture, which is that we've taken actions across the last really six months to make sure the balance sheet is particularly well-positioned. And then the last kind of stage of that, if you will, is the depository franchise. And it is my view that once the depository transaction closes, we will have one of the lowest kind of levered balance sheets of any depository in the country.

The Company's leverage will be at kind of almost historic low levels in its core business. And we will have our credit facilities all renewed. We will have access to deposit-based funding. We will have a very liquid and strong balance sheet. And that we will then go into the market prudently, but the market that we're going to go into is really the single best lending market I've ever seen. So whether it is rediscount or any of our other businesses, we think we will be able to earn returns -- very high returns on well-structured senior loans that are very safe.

Sameer Gokhale - *KBW - Analyst*

Okay. Thank you for that, John.

Operator

Carl Drake, SunTrust Robinson Humphrey.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Thanks and good morning. Question is on the growth. There is a little bit of asset contraction in the quarter, understandably, with all the turmoil in the first quarter. But maybe you could give us a little bit of breakout on the gross originations and then the prepayments in the quarter. And also an outlook in the second and the third quarter about how growth might resume going forward. I think that might be important in the model to get to the point at the end of '08 where you're covering adjusted earnings or the dividend by adjusted earnings.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

And one thing I think you should note, Carl, is that but for the sale of the agencies this quarter, which was a strategic decision that we made -- we didn't have to -- we decided to do it, we would have covered the dividend on adjusted earnings. I think it is worth making that point.

But one of the things I mentioned in my comments is probably around the time of our second-quarter earnings announcement, we plan on providing a whole array of kind of new guidance around the business, all the key drivers of the business. Because we think that will be the time when the depository is closed, we will have worked through the process that we're working through now in terms of planning around the depository, our integration of the depository. Our approval will be in hand, and we will understand that better. And that is when we think is really the best time to provide more specific answers to the questions you are getting at.

I'm not trying to defer the question, but I think we will be able to provide such a full set of answers then that address the reality of the business at that time with the depository closed, that I would rather defer providing some more specifics on that until after that. Because in reality, it is really such a game changer on some of these metrics.

So I don't mean to be kind of punting on your question there, but I just think that in a pretty short period of time we will be able to address some of those things with specific detail and a lot of clarity.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Okay. I understand. One follow-up. On the fee income, it was -- prepaid fee income was down, I think, a 14-basis-point contribution, but the other fee income was still pretty healthy. Maybe you or Tom could talk about the components of that fee income. I assume a lot of that is transaction-fee related. And it was still relatively healthy, given what I think were lower volumes.

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

The prepayment fee income is just lumpy, right? That has been our explanation for that literally every single quarter, and it's true. And then the rest of the fee income is just the normal amortization of deferred fees, plus additional fees that we can charge for various things along the way with borrowers.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

So that little fee income seems to be relatively consistent from a yield contribution, other than the lumpy prepaid part.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Yes, the prepaid fee moves around. It was low this quarter, and it was higher in the fourth quarter. It was low in the third quarter and there was some speculation that maybe this is a new trend based on the credit market. Then it was high in the fourth quarter again. Now it's low again.

Again, these results, to some extent, were negatively affected by two things. One, lower prepayment fees, and also we had some onetime expenses, which Tom mentioned, associated with our TierOne deal being terminated. So in future quarters, we expect both those expenses not to be there and some of these prepayment numbers to stabilize more along the lines of historic levels.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Is there any visibility on this coming quarter on a prepay fee income?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

No, not yet. We are one month into it, so --

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Okay, thank you.

Operator

Jim Shanahan, Wachovia.

Jim Shanahan - *Wachovia - Analyst*

Thank you very much. At the investor day in early March, I recall some discussion about the Company's interest in pursuing a private CLO. In fact, I think that management even commented there had been some meetings that had occurred or some progress had been made. What is the status of that or any similar financing? Does management still have any interest in anything like that?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Yes, we were geared up to do one of those transactions, as we indicated. But in light of the bank acquisition, we've made the decision to move loans into the bank at closing rather than do that. And if we were to execute one of those private CLOs, we would be permanently kind of financing those assets, which would make it difficult to move them into the depository and it would not provide as much benefit immediately as the depository could, if we were to kind of reserve those assets to be placed in the bank.

So we made the decision, based on that transaction being announced. And as you know, at our investor day, that transaction wasn't kind of on the table the way it is now. So we were moving down the path of the private CLO. Once the transaction was announced, we said, hey, a better option is to move these loans into the bank. They're high-quality loans. They're performing really well. They are very attractive bank assets. And it allowed the depository to start with a little more heft. So we made the decision to reserve those loans for placement in the bank. That is really the only thing that happened. But we were moving down the path to getting one of those deals done.

Jim Shanahan - *Wachovia - Analyst*

Okay, thank you. And a brief follow-up, if I may. On Form 10-K, the Company disclosed about $5.6 billion in committed capacity under credit facilities. I believe the number announced today was $4.6 billion. I can't quite get -- tie those numbers together. There were a couple of very small maturities during the March quarter, February and March. Then it looks like the one facility that was $1.4 billion was downsized to $1 billion. But I still don't quite get to a full $1 billion reduction in capacity. What might I be missing here?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Well, you are right. And as I addressed in my remarks, we have brought down some of the commitment levels in some of the facilities because of just our expectations in what we will utilize versus the significantly higher cost to have that unused commitment sitting around. Then there were, earlier in the year, some smaller facilities that we were not really utilizing that we have let go as well.

Jim Shanahan - *Wachovia - Analyst*

When you talk about the facilities that you're looking at renewing early, you're referring to the $1.5 [billion] facility due in August of '08 and the liquidity renewal for the $700 million facility that is actually due in the '09. Is that correct?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

That is correct.

Jim Shanahan - *Wachovia - Analyst*

All right. Thanks very much for clarifying it. I appreciate it.

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Yes, the one that is due in '09 has a renewal date in, I think, June of '08. So those are exactly the two I was talking about.

Jim Shanahan - *Wachovia - Analyst*

Excellent. Thank you.

Operator

Scott Valentin, FBR Capital Markets.

Scott Valentin - *FBR Capital Markets - Analyst*

Good morning. Thanks for taking my question. Just a question on corporate structure. Assuming the bank or the Fremont deposits are acquired, it seems like it is a great opportunity for growth, given the lack of competition and the attractive returns. Is there any thought about the restructure? Maybe does that limit the ability to grow, given the requirement to pay out a substantial percentage of earnings? Would there be any consideration or reconsideration of the structure?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Well, as we -- we have been asked this question before, and at this point there is no planned change to our corporate structure. One of the things that we want to make sure we highlight with investors is that we are actually not required to pay out nearly as much of our earnings as most REITs are because, at this point, the majority of our earnings is actually coming from non-real estate activities, which is our tax rate is so much higher than most REITs. It is lower a traditional C Corp commercial finance company, but it is higher than most REITs.

And one of the benefits of our structure, if you will, which is -- which also means we pay more tax -- is that we really don't have to pay out nearly the percentage of earnings that most REITs do. So that flexibility exists in our structure.

So should we look at the decision you're framing, which the management and the Board look at everything all the time, we frame it around a number of issues, not just ability to retain more earnings. Because we actually have the ability to retain substantially more than we do currently without running afoul of the REIT rules.

Scott Valentin - *FBR Capital Markets - Analyst*

Okay, that was helpful. Then just a follow-up question. Your credit quality remains exceptionally strong. Just curious, reserve to loans was about flat during the quarter. What is the policy or philosophy going forward if you are seeing kind of weakness on the fringes? Is there any thought about building reserves in front of that?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Yes, if our portfolio kind of informs us or tells us through its various kind of statistics and devices or metrics that we use to track the portfolio, the reserves should be higher, we'd move the reserves up. There's really two components of our reserves that result in the total reserves. There's the specific reserves and then there's more the policy reserves. One is designed for known problems and one is designed to cover loans that are inherent in the portfolio -- or losses that are inherent in the portfolio, but those situations have not necessarily surfaced.

So each quarter we evaluate those specifics and policy. Specifics generally tend to be more of a loan-by-loan analysis of problem loans. Policy tends to be looking at historical performance, factoring in current charge-off data that occurs in the quarter and how that kind of informs or changes historical performance. And then also looking at other kind of drivers or metrics in the portfolio. All of those things kind of come together to lead to our reserve levels.

So, should things kind of percolate on the negative side within the portfolio, that would affect our kind of policy -- and to the extent they didn't get to specific reserve level, that would affect our policy reserves.

Scott Valentin - *FBR Capital Markets - Analyst*

Okay, and just one last follow-up question. You've done a good job also on the expense side maintaining efficiencies. Is there a goal there in terms of percentage of receivables or is a better way to look at it maybe percentage of originations?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

We tend to look at the operating expenses as a percentage of assets. That has really been the metric we have tracked and that is what we're focused on.

But also, to elaborate a little bit further on your last question, which John answered, one of the things that affects our allowance as a percentage of our assets is the mix of loans --cash flow versus asset base versus real estate. Correcting for the mix or the change in the mix of the loans, these reserve factors that we use have really been in the same range for several years here, and were developed at a time when the company had much higher levels of nonaccruals.

And we have been for several quarters now here at the lower ends of our historical ranges. So I think we would feel very good about the level of reserves in the business. And if we weren't looking at the economy the way we are, you could almost make the argument to, on a statistical basis, a quantitative basis, to actually reduce the level of reserves. So I think maintaining our reserves at these levels is a very healthy sign for how well reserved we are in the portfolio.

Scott Valentin - *FBR Capital Markets - Analyst*

Thank you very much.

Operator

Tayo Okusanya, UBS.

Tayo Okusanya - *UBS - Analyst*

Yes, good morning. To quick questions. The first one, with the renewed lines, could you talk a little bit about what the costs -- the cost of funding is on those lines versus what the lines cost you in the past?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Sure. They have gone up, as we expected they would. They're all based on a spread to a cost of funds, and it's generally gone from a number that was between 75 and 100 basis points to a number that is between 200 and 225.

Tayo Okusanya - *UBS - Analyst*

So it has gone up about 125 to 150 basis points?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Yes.

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

That's right.

Tayo Okusanya - *UBS - Analyst*

Good. That's helpful.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Interestingly, we had wider spreads this quarter. So directionally, we have been able to [paint] those increased cost of funds and really pass it on to our portfolio largely.

Tayo Okusanya - *UBS - Analyst*

Right. Okay, that's helpful. Then the agency portfolio, two quick questions. These sales that you did in first quarter of '08, I'm just curious why the firm decided not to wait a little bit to try to see RMBS pricing improve versus sign (inaudible) at end of quarter at a loss. Then how do we think about the further sales post 1Q '08 and what the implications would be for 2Q '08, adjusted EPS numbers?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

First of all, we're not agency security traders by nature. At least the senior management of the company isn't. We've got a very high-quality and experienced team that manages the portfolio. But my nature and Tom's nature is that we're not agency traders, so when we make decisions for this company around capital we're not necessarily making bets about how agencies will trade.

We did see a recovery of agencies in the second quarter, and we did execute a lot of our sales in the second quarter. So the first quarter was clearly a very tough quarter for agencies. As you know, spreads really peaked kind around the end of the first week to the beginning of the second week on agencies, really historic widening of spread on agencies occurred in the first quarter. And we did sell some agencies in the first quarter, as you know.

But our business, we really look to the agency portfolio, because we had a view that we were kind of overallocated, if you will, towards REIT compliance assets, that the prudent thing to do was take some of funding risk out of the business and take some of the GAAP earnings volatility out of the business and reduce the size of that portfolio.

Tayo Okusanya - *UBS - Analyst*

Some with the sale of $1.5 billion in second quarter, could you talk a little bit about what gain or loss you expected from that sale?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Sure. First of all, for GAAP, obviously no impact in the sense that all the stuff has been -- on the agency securities has been marked-to-market. The way you can measure this is if you look at the income statement, you will see there's an item in other income that we record for the residential mortgage portfolio.

Then there's another item that we recorded in the adjusted earnings reconciliation. And those two numbers are typically within a few million dollars of each other, the difference being related to the interest accruals on the swaps, for example, in the hedge portfolio. And it's down there in other income geographically, because that is where it's required to be.

So there's typically a few million dollar difference between those numbers related to basically interest income or interest expense, you can think of it on the portfolio.

This quarter there is not -- there is a bigger loss to the tune of about $20 million, $21 million greater difference. And that is the component that is the realized loss for adjusted earnings purposes related to the sale. And that equates to this approximately $0.095 that John mentioned in his remarks.

Tayo Okusanya - *UBS - Analyst*

Great, that's helpful. Just one last question. The core lending spread -- this is kind of going back to some earlier questions -- core lending spread improved by almost 100 basis points, but the net finance margin declined by about 5 basis points. Could you just kind of walk me through the [recorded] filing items between the core lending spread versus the net finance margin, and what is the difference between those two numbers?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Well, core lending spread as we defined it on the call here and in the press release is very simply our yield minus our prepayment-related fees. Prepayment-related fees are this lumpy item and it moves around from quarter-to-quarter, so you subtract out prepayment-related fees and you get to our core yield.

And since we are a floating-rate lender, we will subtract a floating-rate metric, LIBOR, from this core yield and get to that core lending spread. So core lending spread is basically the credit spread we charge on the coupon that is embedded in the coupon on our loans plus the normal core fee income that we earn.

And net finance margin is a different metric. That is the net of -- that is our net investment income, which is our interest income and fee income, minus our interest expense, plus our operating lease income on our direct real estate investments, divided by the average income earning assets. So there's -- you're talking about two different components --.

Tayo Okusanya - *UBS - Analyst*

Okay. So the core lending spread is just on the commercial portfolio?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Right, which is obviously a big part of being our business and our earnings. But the fact that it's a little bit confusing is that the net finance margin is down a few basis points. There was a question about this earlier. That is due to the fact that we are a floating-rate lender and you've got LIBOR as a component of our yield on $10 billion plus of average interest-earning assets. And with lower LIBOR, you're going to see lower interest income.

Tayo Okusanya - *UBS - Analyst*

Okay, great. Thanks a lot.

Operator

David Hochstim, Bear Stearns.

David Hochstim - *Bear, Stearns - Analyst*

John, you mentioned the competitive environment a few times. I wonder if you could provide some color and kind of relate what you're seeing in the way of spreads on new business to what's happening with your funding costs and how much benefit there is on the new business incrementally?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

Yes, I would say that new business on kind of a pure spread basis, depending upon the product -- because we are -- as you know, we've got a variety of senior lending products and some have been more effective than others -- I would say that new senior loans, just focused on spread for a minute, are anywhere from 200 to 500 basis points wider on a spread basis. Literally, some of the products, there's such a lack of liquidity that probably the new spreads are close to 4000 to 500 basis points.

Some of things that are little tighter, more liquid, where the banks are still playing is probably closer to 200.

But there's other components as well that you're able to obtain in this market that is immediately kind of evident, if you will, in terms of the spread on the loan the day you book it, but becomes quite valuable kind of downstream. And those include things like prepayment fees, lockouts on transactions, so that there is prepayments not allowed for several years and if prepayment were to occur, there's a yield maintenance feature.

So there's a whole bells and whistles, if you will, of additional features -- interest rate floors, which we are getting the benefit of now on some of the transactions we were able to do across the last several years. So there is a package of features, if you will, to loans that we are able to kind of garner, if you will, because of the current environment that you can't get normally. But if you're talking about pure spread, you're probably talking 200 to 500 basis points.

David Hochstim - *Bear, Stearns - Analyst*

Then related that to your increased cost of funds, is that the 100, 125 --?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

As Tom indicated, our credit facility spreads are going up 125 basis points, 150 basis points, pretty significant increases. Obviously, based on the numbers I just described, we can pass it on to the borrowers; that I'm not worried about.

But the other nice thing that's happening is with the depository on the horizon, OR cost of funds is actually going to go down. So we will have this dynamic where the lending opportunities -- what I did not mention is the other benefit of lending money right now is the structures are really tight and the leverage levels are lower, so in addition to getting wider spreads, you're getting much better kind of credit packages, if you will. So on a risk-adjusted return, it is dramatically better.

So what the dynamic we will have is we will have that going on on the left side of the balance sheet, if you will. Then as we prudently and carefully integrate the depository into our business and move our business into the depository, you'll have a situation where our net interest margin should widen quite substantially, I think.

David Hochstim - *Bear, Stearns - Analyst*

Okay, thanks.

Operator

Robert Napoli, Piper Jaffray.

Robert Napoli - *Piper Jaffray - Analyst*

Thank you. Just a quick follow-up on the warehouse Lines. What terms, Tom, are you -- are they one year? Are you moving them out two years until they renew? Are you extending renewals --?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Yes, it's a good question, Bob. The $1 billion facility that renewed for one year of pricing, and then it's got an additional year beyond that in terms of an amortization period it needed. So that has got -- from the way I look at things -- effectively a two-year life on it.

Then with respect to these facilities that we are talking about renewing in the near future, that has been a key element of our discussions as well.

Robert Napoli - *Piper Jaffray - Analyst*

So you're looking at -- you're hoping for similar structures? And do you hope to announce something in the month of May in those facilities?

Tom Fink - *CapitalSource, Inc. - SVP, CFO*

Yes, certainly, if not sooner.

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

So that is shaping up well, Bob. But what I want to also focus on one more time is what we're really focused on is the acquisition of the branches and the deposits of Fremont Investment & Loan, because we think from a future funding platform, our business should integrate into the depository and really be funded in the depository. And that is -- even with the great work that Tom and his team have done on the Treasury side, in terms of renewing our facilities and extending them, etc., kind of directionally where we are headed is towards the depository.

Robert Napoli - *Piper Jaffray - Analyst*

That's a great point. In that regard, what is the next signpost that we can look for that tells us that the regulators -- that things are moving along? Can you narrow in on the closing date at all?

John Delaney - *CapitalSource, Inc. - Chairman, CEO*

We can't really narrow in. We have a contractual deadline, if you will, at the end of July. We filed our application, as I indicated, and the application was a very substantial document. And in the application, we not only set forth our business plan, but a variety of things that are required as part of the application. So that has been done and it has been submitted.

We've put together a terrific, really a world-class board for this -- for the depository, which we're very pleased with and think they'll be a real asset for the institution.

So I think at this point, as I said in my comments, it is on track in all material respects. We've done everything we need to do at this point. We've submitted our application. We continue to work closely with the company, which has been a terrific and very constructive relationship. And we're moving forward as hard as we can and we're doing whatever we need to do, both with the seller and with the regulators, to meet the expectations that each of them have.

So there is no real milestone that I can kind of point out to you at this point, other than to say that we are operating on a relatively short time horizon.

Robert Napoli - *Piper Jaffray - Analyst*

Thank you.

Dennis Oakes - *CapitalSource, Inc. - VP-IR*

Thank you, everybody. That concludes our call. Bye bye.

Operator

Thank you for your participation in today's conference. This concludes your presentation and you may now disconnect. Good day.
