FINAL TRANSCRIPT

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the quarter two 2008 CapitalSource Inc. earnings conference call. My name is Robin and I will be your coordinator for today. At this time, all participants are in a listen-only mode and 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. At this time, I would now like to turn the presentation over to your host for today's call, Mr. Dennis Oakes, Vice President of Investor Relations. Sir, please proceed.

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

Thank you, Robin. Good morning, everyone and thank you for joining us for the CapitalSource second-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 will be available beginning at approximately 10:30 a.m. 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 involve 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 risk factors can be found in our reports filed with the SEC.

We issued a press release on July 15 stating our intent to file a registration statement with the SEC for the initial public offering of our healthcare net lease business. CapitalSource Healthcare REIT will be carved out of the CapitalSource healthcare net lease segment and will be managed by CapitalSource. At this point in the SEC registration process, we are legally barred from going into detail on that transaction. As such, we respectfully ask callers not to pose questions today relating to the CapitalSource Healthcare REIT. We are now ready to turn the call over to John Delaney. John?

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

Thanks, Dennis, and good morning, everyone. In terms of the basics, we had GAAP net income of $0.25 per diluted share and adjusted earnings of $0.12 per share for the quarter and continued solid credit performance, particularly in light of a portfolio that was reduced by over 3% across this past quarter. This is in line with the outlook we have provided last week. Tom will walk everyone through the reconciliation of these various numbers when I am finished here.

I would like to focus today on two things. First, what we are seeing in the market and second, what we expect for the remainder of the year. I won't spend any time reiterating the message we delivered last week about the opening of CapitalSource Bank and the strategic importance of the bank to CapitalSource. I think we covered that well on the call.

My only added comment today is that CapitalSource expects to be playing careful offense in this market. As a result, we expect to grow our business and we expect that growth to be smart and highly profitable growth. Being able to do this and by that I mean being able to grow in an attractive market will, to my mind, distinguish CapitalSource as a clear winner emerging from this market turmoil. As always, it bears repeating that we expect to grow while maintaining our historically strong credit performance.

We also have a view that there will not only be unusually good lending opportunities, but unusually good opportunities for strategic moves, particularly in banking. Now there is no free lunch in life and I don't want to be Pollyanna-ish about the economic environment across the next few years that will clearly add some measure of pressure on our portfolio, which has caused us to guide to moderately higher charge-offs, but we think our offense of orientation in lending and potentially in banking will create significant value for our shareholders.

Onto what we are currently seeing. In the first week, CapitalSource Bank approved more than $150 million of new loans with a blended loan to value of 46% and an expected blended all-in yield of more than 600 basis points over LIBOR. These are all very strong credits and these yields and LTVs are consistent with the pipeline we have in front of us. It should be noted that while we are aggressively looking to make loans at attractive spreads, we are as focused at moving our LTVs lower and avoiding sectors and/or companies likely to be more negatively affected by the economic conditions. Put another way, we view this as a great time to make very profitable and very safe loans.

Regarding the second half of the year, our focus is squarely on the future and positioning the Company to our growth in earnings from 2009 through the next five years. As a result, the rest of this year is about laying the groundwork for that growth.

In that regard, we will be restructuring and reducing our non-bank funding programs, positioning our compliance portfolio to get us just through the remainder of this year, investing in our bank so it has the capabilities to manage the growth we expect and finalizing our go-forward bank-like dividend policy that will result in our investing almost all of our earnings in profitable growth. These actions will continue to create volatility in our business, both optically and bottom line, for the remainder of 2008

so we can begin 2009 with a very clean slate. Tom will now provide a more detailed look at the key financial drivers for the quarter. Tom?

Tom Fink - *CapitalSource Inc. - CFO*

Thank you, John and good morning. This quarter's results were in line with our previously announced guidance and as I indicated in the text of the release, we were pleased with both the core performance of our commercial finance business and the credit performance of the commercial loan portfolio.

The second-quarter bottom-line results were a bit unusual however as turbulent market conditions from the first quarter to the second continued to create some volatility in our financial performance. We also saw some increase in certain expense items related to our very important strategic transaction to acquire the CapitalSource Bank branches and deposit funding capability. This is an example of some of the groundwork-laying that John just discussed.

In my remarks this morning, I will focus on the core performance of the Company and also will put some texture behind the major variances from last quarter's results, both GAAP and adjusted EPS, which are primarily flowing below the line through other income this quarter. This should help you understand that, behind this market-induced volatility, our commercial lending business is performing admirably and we are now well-positioned to capitalize on the market opportunity.

As John previewed for the quarter ended June 30, we reported GAAP earnings of $60.1 million, or $0.25 per diluted share. Adjusted earnings was $29.1 million, or $0.12 per diluted share. Net investment income was $160 million for the quarter, down approximately $20 million, primarily as a result of an increase in our commercial finance borrowing spread to LIBOR.

On the yield side, our core lending spread to LIBOR remains strong at 7.05% and prepayment-related fee income was higher in the quarter, contributing 43 basis points to yield this quarter, up from 14 basis points last quarter.

One of the reasons our core lending spread remains strong is that, similar to the first quarter, we are continuing to see the benefit from interest rate floors that we structure in many of our floating-rate loans. Approximately 94% of the portfolio is floating-rate loans and of this amount, approximately 44%, or 41% of total loans, have interest rate floors. With the decline in short-term market interest rates, almost all of these floors are now active and contributed to this overall yield enhancement.

As I mentioned earlier, despite the continued strong yield performance, net investment income was down in the quarter due to an increase in our commercial finance borrowing spread. That borrowing spread to one-month LIBOR was 281 basis points, up 66 basis points from last quarter. This increase is largely due to an increase in deferred financing fee amortization and higher credit spreads. The increase in deferred financing fee amortization was in part related to the start of CapitalSource Bank and in that sense, was more of a one-time item. So let me try to explain that a bit.

At the commencement of the bank in July, we sold approximately $2.1 billion of our commercial loans to CapitalSource Bank. These loans have been financed at CapitalSource both with credit facilities and with some of our term debt -- the single investor CLOs you may recall that we completed at the end of last year.

In connection with the loan sale to the bank, we called some of that term debt and also decreased some of our credit facility commitments. While the loan sale occurred in July, we knew for the second quarter that we would have a much shorter expected life for these financings and with that shorter expected life and lower commitment levels on the facilities, we needed to increase the amortization and accelerate some of the deferred financing fees into the second quarter. In total, approximately $27 million of our interest expense this quarter was deferred financing fee amortization and of this, approximately $10 million was related to the acceleration due to the loan sale to the bank.

Credit remained very good in our commercial finance segment this quarter. Provision for loan losses was $27.5 million and charge-offs were $23 million for the quarter, both up from very low levels in the first quarter. The important story we want to focus you on here is that our credit performance has continued to be good and our credit metrics, as we have guided, have remained within our historical levels.

60-day delinquencies as a percentage of commercial assets were 1.05%, up 36 basis points, but in the range of 65 to 130 basis points over the past 10 quarters. Non-accruals were 1.99%, up 37 basis points and also in the range of 155 to 230 basis points that we have seen over the past 10 quarters. And finally, charge-offs at an annualized rate of 90 basis points were similarly in the range of the past 10 quarters of 20 to 120 basis points.

This is a good time to remind everyone that our credit metrics can move around quite a bit from quarter to quarter. Our performance in the second quarter however was very good, both with respect to our expectations and our guidance for the business.

This quarter, our adjusted EPS was lower than our GAAP earnings and it is unusual for that to happen. Most of this can be explained by items in other income where we saw some positive items benefit GAAP earnings, but not adjusted EPS. And we also saw some items negatively affect adjusted EPS that did not affect GAAP results this quarter. In particular, in the second quarter, we saw GAAP gains related to mark-to-market improvements in our residential mortgage investment portfolio and GAAP gains related to marks on our derivatives in our commercial lending portfolio. These GAAP gains were significant turnarounds from substantial mark-to-market losses in these items for the first quarter. When compared to our GAAP results -- when comparing our GAAP results and adjusted earnings, it is important to note that while these mark-to-market gains increase GAAP earnings, they do not affect and do not benefit adjusted earnings.

Also in the second quarter, we saw the realization in adjusted earnings of certain losses related to the residential mortgage portfolio and commercial finance derivatives. These previously unrealized losses had been reflected in prior GAAP results, but were reflected in adjusted earnings this quarter due to the final realization of these items. Specifically, GAAP gains related to the residential mortgage investment portfolio were $9 million, up $64 million from last quarter's loss of $55 million. The GAAP gains are due to the increase in the value of the residential portfolio due to a tightening of mortgage security spreads that we saw during the quarter.

For adjusted earnings, we saw a $48 million or approximately $0.20 per share realized loss on the residential portfolio in the quarter. This is up $20 million from last quarter's adjusted earnings loss as a result of the sale this quarter of over $1.5 billion of our excess agency MBS.

Similar to the residential mortgage investment portfolio line item, GAAP gains on our derivatives in our commercial lending portfolio were $15 million, up $53 million or approximately $0.23 per share from last quarter's loss due to unrealized gains related to a steepening of the swap curve.

As you will recall, we use some interest rate derivatives in our commercial lending business to mitigate interest rate risk between our fixed-rate loans and largely floating-rate funding sources. We do not employ hedge accounting, so when we mark these hedges to market, the underlying loans are not marked to reflect the corresponding change in their fair value. These gains increase our GAAP earnings, but they are backed out of adjusted earnings.

We also saw in the second quarter an adjusted earnings loss of $18 million or approximately $0.07 per share related to the commercial finance derivatives. This was largely due to a $13 million adjusted earnings realized loss related to the winding up of our CLO asset management business for broadly syndicated and middle-market loans. We have provided a limited guarantee to warehouse financing for an approximately $300 million pool of assets we were assembling for a CLO, which we intended to close about the time the market disruption began last year. We had been marking that guarantee to market as a derivative and the marks had been run through prior GAAP earnings. During the second quarter, we terminated this financing and therefore recognized the results in our adjusted earnings this quarter.

The last variance I want to speak about for this quarter is tax expense. And this affected both GAAP and adjusted EPS. Tax expense increased $34 million or approximately $0.15 per share over last quarter due to three factors. First is greater TRS income; second, is a discrete item related to the settlement and conclusion of certain federal and state tax audits, which accounted for about $3 million of incremental tax expense this quarter; and third is a higher tax rate based upon our forecast and an update of our forecast for the mix of income this year.

As we have discussed before, to properly provide for income taxes throughout the year, we have to estimate how much income will be earned in the REIT versus how much will be earned in the taxable REIT subsidiary or TRS. Forecasting the mix of where our income will be earned is somewhat hard to do, but this quarter the change is important due to CapitalSource Bank, which is in our TRS.

In the second-quarter tax rate calculations, we included CapitalSource Bank in our forecast for our mix of income. This shifted the mix of income towards more of it being earned in the TRS resulting in a higher effective tax rate. We are now projecting a full-year income tax rate of 35%.

Before turning the call back to John, I wanted to take one minute to publicly thank all of the employees of CapitalSource. I can speak best of course to my own finance function, but they and really all of the employees of CapitalSource have done a terrific job for this Company. For all of our years as a public company and significantly during the past 12 months, this entire group of employees has worked very hard and put in a tremendous effort and the results I think are very clear.

While the market disruption is not over and we certainly have plenty of work left to do to realize the full potential of CapitalSource, our new bank and the opportunity this market is now providing us, I think we have navigated through these years and in particularly the last 12 months extremely well. So I just wanted to say thank you and acknowledge all of their hard work.

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

Thanks, Tom. And at this point, we will open it up for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Bob Napoli.

Bob Napoli - *Piper Jaffray - Analyst*

Good morning, guys. I try to shoot a couple quick questions at you. Just, Tom, on the tax rate, 35%, so you would expect, if your model hit exactly, that 35% would be the tax rate in both the third and fourth quarters?

Tom Fink - *CapitalSource Inc. - CFO*

That's correct.

Bob Napoli - *Piper Jaffray - Analyst*

Okay. And as far as growth -- now that you have the bank, John, are you expected -- what would you expect to see over the next few quarters as far as growth? Would you expect kind of flattish assets and then growth in the fourth quarter because it takes some time to kind of get the machine restarted or what would you expect on the asset growth side?

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

Well, without giving you a specific number, Bob, I would expect the asset growth or the assets to be up second quarter to third quarter. As I indicated in my comments, in the first week of the bank's existence, we approved about $150 million of new loans. And we really, I would say, are probably 75%, 80% kind of hitting on all cylinders, if you will. And so I think things are ramping up nicely. The market is very attractive.

As I said in my comments, we plan on proceeding carefully. There are some -- we have some fairly strong views about certain sectors and certain types of transactions that we view as more attractive from a credit perspective in today's market. But fortunately, even with those kind of I think well-informed views as to where we want to allocate our capital, we are seeing lots of opportunities. So I would expect assets to be up second quarter to third quarter and for that to continue for the next several years based on what we are seeing in the market.

As we indicated last week, we did guide towards kind of $3 billion to $6 billion of originations per year across the next several years. That is a fairly significant spread and I think what informs the originations on each end of that range is the lower end is kind of more the direct origination range and as we get to the higher end, it is because we are anticipating a certain portfolio or business acquisitions and business acquisitions really being portfolio acquisitions that could move that number up. But I would expect good growth to start this quarter.

Bob Napoli - *Piper Jaffray - Analyst*

Okay. Can you give any guidance on the net finance margin in the commercial finance business for the third quarter and fourth quarter with the bank? Kind of integrating the bank into that.

Tom Fink - *CapitalSource Inc. - CFO*

Yes, Bob, we haven't really provided and aren't really intending to provide that specific level of guidance. I think certainly, outside the bank, our cost of funds will remain high. We saw an increase in cost of funds this quarter in part due to the deferred financing fee amortization I mentioned, but we are also seeing the higher credit spreads now related to the restructuring or -- excuse me -- the renewal of all of our credit facilities earlier in the year. But loan yields I think generally as John described before is what we are looking for.

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

Yes, I mean the bank as a standalone business should have higher yields and lower cost of funds than CapitalSource has had historically. And the plan is to migrate a large percentage of our business into the bank across the next several years. So I think directionally, that is where we are headed. How that affects the whole CapitalSource in the short term, I don't think we are giving any specific guidance around that yet.

Tom Fink - *CapitalSource Inc. - CFO*

And then the last point, too, I think the other thing that is important not just for the third quarter, but for all the future is how quickly we deploy the capital and how quickly we achieve these originations we expect. As you know, we did raise some common stock in the second quarter, which decreased leverage certainly at the end of the second quarter, but we would expect to see lower leverage on average in the third quarter.

Operator

Don Fandetti.

Don Fandetti - *Citigroup - Analyst*

Good morning. A quick question -- on your healthcare portfolio, it looks like the net income was down or the yield was down. Anything specific there?

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

No, I don't think there is anything specific there. We did make one adjustment in our lease income related to just how we are providing for the contractual increases that occur in the lease rents. But other than that, the portfolio is pretty stable quarter over quarter and what we are looking forward to, certainly with the IPO of CapitalSource Healthcare REIT, is for that business also too to get back onto a growth trajectory.

Don Fandetti - *Citigroup - Analyst*

I mean it seems like the income came down notably. When you say you made some changes, I am not sure if I follow.

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

The rents in the -- the leases provide for escalation. So every year, the rents escalate based on a factor and it can be a static number. It can be based on inflation. It can be the lower of, it can be the higher of. And what we have in the quarter is a $3 million adjustment, roughly speaking, for a couple of leases where we had been providing for that incorrectly. It was an immaterial change. So that's more of a one-time item and I would look forward to that lease portfolio getting back to the run rate it had been on.

Don Fandetti - *Citigroup - Analyst*

Okay, so it will bounce back.

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

Yes, that's right.

Tom Fink - *CapitalSource Inc. - CFO*

Yes, I mean it is kind of a catch-up item because of the change in the way that is recognized. So the change is more severe when you actually make the change than what it is going forward.

Don Fandetti - *Citigroup - Analyst*

And then I guess looking back at your capital raise, John or Tom, I mean it is unclear sort of when you're going to deploy that capital. Do you still sort of think that that was the right move and was it more of a delevering event or more of an opportunistic type event?

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

Well, I think when you delever, you put yourself in a position to be more opportunistic, so those are probably related. Yes, we definitely think it was the right move.

Don Fandetti - *Citigroup - Analyst*

Okay. A then on the credit side, are there any areas that you would sort of rank as the stronger and then others that would be weaker in terms of the outlook?

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

I think we have always had a view that the two areas that are likely to experience more headwinds are kind of our commercial finance book of business, which is the portfolio of kind of about a third of our business, but diverse portfolio of middle-market LBO loans, which is, as I said, roughly 29% of our business and then our commercial real estate business, which is 18%-ish of our business. Those are the two areas that are likely to experience more headwinds with the other areas we think largely unaffected by what is going on. So I would say that remains true.

Don Fandetti - *Citigroup - Analyst*

Okay, thank you.

Operator

John Hecht.

John Hecht - *JMP Securities - Analyst*

Good morning. Thanks for taking my questions. Could you give a little bit more detail with respect to gross originations and prepayments in the quarter and maybe in that a little bit of a reflection of given you think this is going to be good growth period for the Company, what type of loan products and segments in the coming quarters you would be focused on?

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

Why don't I start with the second half of the question, John as Tom gathers the information for the first half of the question. In terms of where we are focused, there are certain -- let's break our business down into components. Our healthcare business has been a consistent focus of ours and we expect that to continue. There is nothing about that business right now that we don't like. We think it is a good place to be allocating capital in this kind of an environment. Fortunately, we have got a very good presence in the business, we have got a lot of expertise in the business. That's a natural area for us to grow aggressively.

I think when you back away from there, you go to some of our asset-based businesses, which have a similar profile where you are really lending based on assets and that is generally a more defensive way to play in this environment. And so again, I think we have a general focus on things that have an asset orientation. So those two things cover about half of the portfolio.

And then you get back to the broadly kind of syndicated corporate finance business and then the commercial real estate business. I think in the corporate finance business, we are focusing on really moving up the capital structure as much as possible, which we have an opportunity to do. In today's kind of LBO environment, you can make very senior loans, things well below 50% LTV and actually with some larger companies and more diverse and more balanced businesses. We also have a focus on some industries that we think are a little more defensive -- energy, technology, some things like that.

In commercial real estate, which we are looking at, there is a tremendous lack of liquidity in commercial real estate right now and I think unlike the residential real estate business, which there is kind of a broad depression across the country in commercial real estate, you can still do property-specific underwriting and come up with an underwriting view or a credit view of a single asset that may be different than your overall view of the commercial real estate market. And by that I mean our overall view of the commercial real estate market is not particularly bullish, but that doesn't mean you can't find specific properties or specific projects that you can underwrite very well.

So I think in commercial real estate, we view it as an opportunity because there is such a lack of capital in the markets and we can work we think with some very fine commercial real estate investors and by that I mean large financial sponsors and do some low loan-to-value lending on properties where we can underwrite because of what is going on in that particular submarket. A good example of that is we are looking at a bunch of deals in downtown Washington DC, which is a very attractive commercial real estate market and to the extent you are lending in commercial real estate, that is where you want to do it and we are doing it with some -- we are looking at opportunities with some very fine, well-regarded kind of branded private equity sponsors.

So I think I would describe our orientation as very focused on healthcare, very focused on asset-based lending and in corporate finance and commercial real estate, it is a more focused approach. In corporate finance, it is focused on very low loan-to-values with industries that we think are more defensive and in commercial real estate, it is really kind up picking needles out of a haystack, if you will, in terms of properties that we think you can do very good underwriting around and just avoiding things that are hard to underwrite.

There are certain sectors -- I mean no matter how low the loan-to-value is on a condo loan today, to some extent you can't underwrite it because of what is going on in the market. So you really -- you have to focus on stuff you can underwrite in commercial real estate and that leads us towards a more focused approach. So now I will turn it over to Tom who will give you some specific numbers.

Tom Fink - *CapitalSource Inc. - CFO*

Sure. So I think your question was about the payoffs in gross origination versus the net. As you know, we always try to focus people on the net because I don't -- we really haven't found too much information in breaking out the amount of payoffs versus the amount of originations. But since you asked, in the quarter, we saw about just under $500 million in payoffs, which is what really drove the $330 million decrease in the portfolio quarter over quarter.

And in terms of that volume, it is, I would say, a fairly normal looking quarter in that regard. We certainly have had quarters where we have seen less prepayment volume and we have seen quarters where we have had more prepayment volume. So this is sort of in the middle of the road.

John Hecht - *JMP Securities - Analyst*

Okay, and just to be clear, the 5.4% cost of funds that you highlighted in the commercial finance segment, that includes the $27 million of deferred finance fees?

Tom Fink - *CapitalSource Inc. - CFO*

Yes.

John Hecht - *JMP Securities - Analyst*

We can figure it out, but can you tell us what that would have been excluding that $27 million?

Tom Fink - *CapitalSource Inc. - CFO*

What the rate would be?

John Hecht - *JMP Securities - Analyst*

Yes.

Tom Fink - *CapitalSource Inc. - CFO*

Yes, I don't have that at my fingertips, but the important point I was trying to focus on, and you may have picked up on it, was that about $10 million of that $27 million was due to the acceleration related to us selling loans to the bank.

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

So put another way, $17 million would have been there.

Tom Fink - *CapitalSource Inc. - CFO*

Correct.

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

Either way. You see what I mean? So it is really an incremental $10 million.

John Hecht - *JMP Securities - Analyst*

It's a $10 million adjustment.

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

And I think it is important -- I want to dwell on that for one second. I mean we have been saying this for some time. The difference between the cost of funds in the bank and the cost of funds outside the bank is quite significant. We were able to successfully

roll all of our credit facilities in the first half of this year, but I would say that came with a significant cost and the increase in the cost of funds in those credit facilities could certainly be described as dramatic, which is why our emphasis going forward is on funding assets in our bank as opposed to funding assets outside the bank because the cost of funds outside the bank is actually quite high.

John Hecht - *JMP Securities - Analyst*

Yes. So given the last quarter along with where we are seeing kind of treasury curves and interest rates and where we have seen them come, it seems that we should kind of visualize this -- in terms of the asset yields, we should start seeing a stabilization going forward. Is that a fair statement?

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

Of asset yields?

John Hecht - *JMP Securities - Analyst*

Yes, a stabilization if not a slight increase in asset yields going forward given where credit spreads are going and where you are putting new loans on the book?

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

I think my bet would be on an increase going forward.

John Hecht - *JMP Securities - Analyst*

All right, thank you very much.

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

I mean it's a big book of business, so it takes some time to move the needle of course, but directionally I would bet on an increase.

John Hecht - *JMP Securities - Analyst*

Understood. Thanks very much.

Operator

Scott Valentin.

Scott Valentin - *Friedman, Billings, Ramsey - Analyst*

Good morning, thanks for taking my question. Just focusing on the credit quality aspect, it looks like nonperforming loans increased a little bit as did delinquencies. Just curious as to where you're seeing it. Is it the LBO segment you mentioned earlier as being an area you are worried about or the commercial real estate? And secondly, can you talk about the granularity of the credits? Are there several large credits or is it mostly smaller credits?

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

I would say there is nothing about -- I mean the absolute dollars didn't grow really grow that much at all. The portfolio shrank, which contributed to the statistics increasing. I would say that, as I have said in my earlier remarks about credit, I mean we view the corporate finance business and the commercial real estate business as the areas that are experiencing more headwinds and most of the problem loans in the non-accrual bucket for example or the delinquency bucket come from those two areas. And there is nothing about the nonperforming loans this quarter that was more lumpy than others. I think it was really one loan moving into the non-accrual category that I think moved the numbers there. I think I am right there. I don't know, Tom, if -- I think it is principally one loan that moved the statistics. So I don't think there is any really new information coming out of those numbers.

Tom Fink - *CapitalSource Inc. - CFO*

I think relative to the guidance we have given, this is actually I think a very good quarter and as I have said a couple of times, the portfolio from a credit perspective is performing very well. We have most recently gave some guidance regarding annual charge-offs and as well as the historical range for non-accruals and delinquencies and we continue to stay within that range as we expect.

Scott Valentin - *Friedman, Billings, Ramsey - Analyst*

Okay, thank you.

Operator

Mike Taiano.

Mike Taiano - *Sandler O'Neill - Analyst*

Hi, thanks. Just following up on the credit metrics, was the Haven Healthcare situation -- did you guys take a loss on that in this quarter or was that something that you ended up being made whole on?

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

No, we didn't take a loss on Haven Healthcare and that situation is still resolving itself and we don't anticipate taking a loss.

Mike Taiano - *Sandler O'Neill - Analyst*

Okay, great. And then maybe just on sort of what the paydowns going forward here. I think historically you guys have said your loans are somewhere, in terms of duration, in the three-year sort of range. I mean should we expect that term to lengthen going forward or do you think it will remain fairly stable?

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

I would expect it to lengthen. I mean I think that there is less -- the vast majority of our loans get paid off, not really through a refinancing, but through some M&A activity with the underlying borrower or asset and obviously in light of today's environment, there is less liquidity and the transactional nature of the market is obviously reduced and I think that will translate into stretching

out kind of the weighted average life of our loans. We don't actually have a firm view as to how much that will stretch out, but I think we are modeling reasonably decent lengthening of the weighted average life if you will. So call it an extra six months to a year across the portfolio, which is pretty significant on a large portfolio.

Mike Taiano - *Sandler O'Neill - Analyst*

Great. And then just final question, on the $19.2 million that you had in other income, how much of that was related to the gain on the extinguishment of debt?

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

I don't know if we have that because some of that was stretched into this quarter.

Tom Fink - *CapitalSource Inc. - CFO*

I think it is about $14 million of that other other income and then we'll see some more in the third quarter.

Mike Taiano - *Sandler O'Neill - Analyst*

Great. Thanks a lot.

Operator

Jeff Davis.

Jeff Davis - *FTN Midwest Securities - Analyst*

Good morning. John, with the change in the structure of the Company, at least from a funding perspective, are there depositories that you would look at that you would say that is a reasonable comp for CapitalSource? I know -- I guess you have always looked to iStar, at least to some extent, on the commercial real estate side.

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

Yes, I would say that, without naming specific names, we have developed a group of what we consider to be business banks, kind of mid-sized business banks that -- and by that I mean they are principally in the business lending sector or commercial lending sector as opposed to being in the real estate sector or the housing sector where so many banks are. I mean our real estate business, our commercial real estate business is call it 18% of our portfolio, so we kind of characterize 82% of our business as business lending because even our healthcare real estate business is really business lending as opposed to the real estate business, at least how we think of it.

And so the comp set, and Jeff, probably the best thing is Tom can give you some of this off-line as opposed to us naming a bunch of other companies on a large call like this, but we do have a comp set of what we call business banks that has been compiled for us by some people we have asked to look at this for us. It is about half a dozen names of banks that are principally engaged in business lending and have deposit-gathering capabilities.

Jeff Davis - *FTN Midwest Securities - Analyst*

Okay, that's fine. I will follow up with Tom.

Tom Fink - *CapitalSource Inc. - CFO*

And Jeff, just to add on that, I think you did touch on what I think is a very good point because certainly as we go through all the steps we are going through here with CapitalSource Bank and then also looking forward to CapitalSource Healthcare REIT IPO, I think the business does get much easier to compare because there are some square-on peers for the healthcare REIT business and then our commercial finance business does look much more like these commercially-oriented banks John was talking about.

Jeff Davis - *FTN Midwest Securities - Analyst*

Okay, thank you.

Operator

Darrin Peller.

Darrin Peller - *Lehman Brothers - Analyst*

Thanks, guys. Real quick on the -- the way to think about this, we have net finance margins of 5% to 6% in the commercial portfolio right now. With loans generating yields, it sounds like there were 400 or 500 basis points wider right now. What kind of returns on those loans, kind of new commercial loans, should we expect on an ROE basis? I mean your ROE now is about 8%. If we compared the 8%, 9% now to let's say a year out from now on all the new loans you have originated, what can we expect?

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

Well, I can tell you what we are targeting and we are steering the business in this direction, which is a 15% after-tax ROE, assuming we pay out the higher measure of tax, meaning 39%. So that is what we are targeting for the whole Company and that is where we are steering all-new originations.

Right now, we are somewhat underlevered relative to what we view as stabilized leverage and even our stabilized leverage is much lower than what you find in many banks because we expect to run the bank with higher capital just because we can. So as we get closer to kind of 4.5 to 1, 5 to 1 leverage, we expect the business to run at a 15% after-tax ROE, assuming a full measure of tax.

Darrin Peller - *Lehman Brothers - Analyst*

All right. So the 15% after-tax ROE, that is assuming still the 15% capital ratio in the bank or you are saying that is after bringing that down a bit?

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

No, that is assuming that level of capital.

Darrin Peller - *Lehman Brothers - Analyst*

Okay. And over time, that might be able to come down as well.

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

Yes, it might, but I just don't see -- I think financial flexibility for us across the next several years is going to be very important. And when I say financial flexibility, not only in terms of ability to do deals in terms of loans, but potentially the ability to do other things, particularly in the banking sector and I think having a high capital ratio will be an asset. So we are not really actually modeling that capital ratio coming down in the next really five years to be honest with you. Not because we don't think we can, but just if you do the math with the business with the amount of earnings we will retain, etc., we just don't think we are going to get there.

Darrin Peller - *Lehman Brothers - Analyst*

When you talked about $36 billion of new originations per year, I mean is that -- I think the question started coming up earlier on the call, but that should be assuming starting really now, next quarter, fourth quarter? That kind of run rate?

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

Yes, I think that's right. I mean it is reasonable to assume third quarter will be a little below that run rate, but not materially below.

Darrin Peller - *Lehman Brothers - Analyst*

And that includes --

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

(multiple speakers) -- ramping up. I'm sorry, Darren?

Darrin Peller - *Lehman Brothers - Analyst*

That includes portfolio acquisitions?

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

Yes, yes. What I was kind of saying is that is a pretty big gap and really what informs it on the high end is portfolio acquisitions.

Darrin Peller - *Lehman Brothers - Analyst*

Great. And in terms of portfolio acquisitions, is this going to be a focus on mostly sort of the healthcare area?

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

No, I don't think so. I think we will look at it across all the different -- let me say this. We won't look at stuff that is really outside our area of competency. So we won't be looking at assets that we don't already originate and underwrite and know something about. So the only limiting factor at this point, it will be in areas where we have some expertise. But I think otherwise, we are looking across all the businesses.

Darrin Peller - *Lehman Brothers - Analyst*

Okay. Thanks, guys.

Operator

At this time, I would like to turn the call back over to Mr. Dennis Oakes, Vice President of Investor Relations. Please proceed.

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

Thank you, Robin and that is it for today. Just a reminder that the call will be archived and up on our website later this morning. Thank you, everyone.

Operator

Ladies and gentlemen, at this time, you may now disconnect. Good day.
