FINAL TRANSCRIPT

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the second-quarter 2005 CapitalSource earnings conference call. My name is Michelle and I will be your coordinator for today. At this time all participants are in a listen only mode. We will be facilitating a question-and-answer session towards the end of today's conference. (OPERATOR INSTRUCTIONS) As a reminder, today's conference call is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Mr. Tony Skarupa, Finance Director. Please proceed, sir.

Tony Skarupa - *CapitalSource, Inc. - Finance Director*

Thank you Michelle, and good afternoon. Joining us today are John Delaney, Chairman and Chief Executive Officer of CapitalSource; Jason Fish, our President; and Tom Fink, our Chief Financial Officer.

Before I turned a call over to John, I want to inform you that this call is being wet cast on the investor relations section of our website @www.CapitalSource.com. Furthermore a recording of the call will be available on the website beginning at approximately 7:30 this evening and our press release and website provide details on accessing the archived call.

Also before we begin, I need to inform you that statements in this earning 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 and operating results involve risks, uncertainties and contingencies, many of which are beyond CapitalSource's control and which may cause actual results to differ materially from anticipated results. More detailed information about these risk factors can be found on our annual report as filed with the Securities and Exchange Commission on Form 10-K.

CapitalSource is under no obligation to and we expressly disclaim any such obligation to update or alter our forward-looking statements whether as a result of new information, future events or otherwise.

Now I would like to turn the call over to CapitalSource's Chairman and Chief Executive Officer, John Delaney.

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

Thanks Tony and thank you everyone for joining us today. I'm pleased to report our second-quarter earnings which we viewed as very strong. Our net income for the quarter was 45.5 million or $0.39 per diluted share. This is a 16% increase over our first-quarter earnings and a 63% increase over the second quarter of last year.

Several favorable items drove these results including higher prepayment related fee income, lower specific reserves and an uptick in realized equity gains and other income compared to the first quarter. We discussed last quarter how some of our lumpy income and expense items cut against us that quarter. This quarter demonstrates the earnings power of the business when some of the items, not all, but some of these items cut our way.

I'd like to spend a few minutes giving you an update on the lending businesses, growth in the competitive environment and then spend some time on credit.

We saw good growth again this quarter. Our portfolio balance at June 30 was $5,069,000,000, an increase of 352 million from March 31 and an increase of 795 million year-to-date. As we are more than halfway there already, we feel good about our 1.5 billion net growth target for the year.

We continued to see the business unfold as we predicted. That is our Healthcare and Specialty Finance business would be a very strong grower this was our prediction and that Corporate Finance would grow substantially less than last year with Structured Finance being a solid steady grower. In the second quarter, our Healthcare and Specialty Finance business, which as most of you know is an asset-based lending business, saw the strongest growth and became our largest business during the quarter representing 37% of our total portfolio at June 30.

Healthcare and Specialty Finance is reflective of the Company's overall migration towards more asset-based lending which is further reflective of really two things. First, the strength of our business groups that are focused on asset-based lending. And two, our general defense of posture in what we would categorize as a credit rich environment. Healthcare and Specialty Finance grew a net of 263 million for the quarter which included the purchase of a diverse pool of healthcare real estate loans that

occurred in June. In general, we also saw good origination activity in Healthcare and Specialty Finance this quarter and currently have a very strong pipeline in that business as well. So we believe the prospects for the business are excellent for the rest of the year.

Corporate Finance, which was 35% of our total portfolio at June 30, was essentially flat in the quarter. Solid deal flow and new originations were offset by very high levels of prepayments. In fact, Corporate Finance's balance actually was down in the quarter because of this prepayment activity.

And finally, Structured Finance representing 29% of the portfolio had a good quarter with solid growth in its portfolio of just over 10% compared with to its portfolio at the end of the first quarter. Structured Finance continues to be a steady growth engine for the Company and we particularly like how our real estate business is developing and continue to see good opportunities in our rediscount finance business.

With respect to credit, I think the headline this quarter is that overall credit quality remained very good and in accordance with our expectations. During the quarter we recorded charge-offs of $5.6 million. These charge-offs effectively had no impact on our second-quarter results as all but 58,000 of the charge-offs had been reserved in prior periods. These charge-offs equated to 47 basis points annualized for the quarter. And for the first two quarters of the year, our annualized charge-offs were 24 basis points.

Regarding reserves, we recorded total previsions of $5 million this quarter including specific reserves compared to 9.9 million in the first quarter. This decrease in provision was due primarily to a decrease in the amount of specific reserves taken. Specific reserves were 3.89 this quarter compared with 8.7 million in the first quarter which moves us back toward our guidance for the full year.

In addition, with the continuing shift in the mix in the portfolio to more asset-based lending, our general provision as a percentage of assets is blending down in accordance with the way our loan loss policy is structured.

Our total allowance for loan losses on the balance sheet including specific reserves at June 30 was 88 basis points, down from 96 basis points in the first quarter. This decrease was due to the charge-off, which I discussed, which contributed 11 basis points of the decrease and again to the change in the mix in the portfolio towards more asset-based and real estate finance.

Our other credit metrics were in line with our expectations with delinquencies flat compared to the first quarter, non-accruals up and an increase in the amount of impaired loans. As a reminder, our credit categories include really three, loans 60 or more days delinquent, which is the delinquent category; loans on non-accrual, meaning we are not currently recognizing any income on the loan; and impaired loans, which means one of two things, either we think there is an impairment in the loan and we have specifically reserved against and don't believe we will be able to recover the full amount of the loan. Or two, loans that are considered definitionally impaired where we don't think we will get paid in accordance with the contractual terms of the original loan agreement. But we still expect to be repaid in full.

In many cases a definitionally impaired loan is only impaired due to this accounting requirement and we feel that the loan is otherwise money good and will not require a specific reserve. This is an important distinction for us that we had discussed with many of you in the past.

As we disclosed in our press release, we had approximately 198 million of loans in one or more of our categories at June 30. The 198 million of loans in these categories represents 3.9% of our portfolio as of June 30 which compares to 165 million, or 3.5% of the portfolio as of March 31.

Now let me take a minute to foot to the changes in this category, this total problem loan category. From March 31 to June 30, we added to new situations to the impaired loan categories. One of these situations was a corporate finance loan without a specific reserve. And one of these new situations was a real estate loan with a specific reserve. In addition, one loan essentially

or substantially left the category. This was a corporate finance loan that we charged off most of the loan -- there's a small stub left -- but most of the loan was charged off this quarter with a 61% recovery rate.

And then the category further increased because we acquired a piece of a loan in from a co-lender in our Corporate Finance Group that was an asset-based loan that we purchased at a discount and since that loan was in the problem loan list, this additional piece that we purchased went into the problem loan list.

So the changes in the problem loan list was essentially one new situation. If we drill down a little further into the non-accrual category which is obviously a subsidiary of this larger total problem loan category, the non-accrual category grew from about 1.5% at the end of the first quarter to 2.2% at the end of the second quarter. Again, there were two new situations in the non-accrual category. One was a real estate loan with a specific reserve that I just discussed in the problem loan category and the other was a corporate finance loan that was already an impaired loan. It just migrated to the non-accrual category and it doesn't have -- and it has a specific reserve against it.

In addition, we had the one loan that was substantially charged off from the corporate finance group plus the stub piece that we acquired from another co-lender. So again in the non-accrual category, it's essentially one new situation that drove these results.

In addition, I want to mention that we had one situation in our healthcare business that became a delinquent loan during the quarter but we resolved it at a full 100% recovery during the quarter.

So that is an update, or a footing, if you will, on the changes in some of those categories. It's essentially one new situation.

A few months ago we also released some information around our recovery experience as a way to provide additional texture to the other credit information. An update to the recovery analysis we provided last quarter -- or as an update to this recovery analysis that we provided last quarter since June 30, 2003, CapitalSource has reported 21 loans totaling approximately 255 million as delinquent or non-accruals. That is the total number of loans since June 30 that went into one of these categories, delinquent or non-accrual.

Of these 21 loans, 13 loans totaling approximately 132 million have been resolved with an average net recovery rate of 89%. The net recoveries by type of loan are as follows. For senior secured asset-based loans, there were two loans out of the 21 with a $14.2 million balance with an average recovery of 93%. There were four senior secured cash flow loans with a $50.8 million balance that had an average recovery of 80%. And there were seven first mortgage loans with a $66.6 million balance with an average recovery of 96%.

So that's the historical recovery statistics which we plan on disclosing on a regular basis and the net recovery rate is running at 89%. And now at June 30, 2005, eight loans remain in this category totaling 122.9 million, and we have 11.3 million of specific reserves against those loans. They break down as follows. There were three loans that are senior secured cash flow loans with a balance of 52.3 million; and there were five loans that are first mortgage loans with a balance of 70.6 million.

As we have said before, we expect our recoveries to stay strong with senior secured cash flow loans having the most volatility.

So with that update on credit and an overview of the business groups, I'd like to turn it the over to Jason who will go through the results in more detail.

Jason Fish - *CapitalSource, Inc. - President*

Thank you, John. As mentioned up front, we had a very strong earnings quarter. Contributing to these results were strong yields in our portfolio, lower credit provisions and good improvements in other income. Let me go through those items and some other items in a little more detail.

Yield increased quarter to 12.59% up 113 basis points compared to the first quarter. A major factor in this increase was prepayment related fee income which contributed 13.1 million to income or 105 basis points in the yield this quarter, compared to 4.8 million in prepayment related fee income or 41 basis points last quarter. The higher prepayment fees we received this quarter reflected a higher dollar amount of prepayments than both last quarter and what we generally expect to see.

There were also increases in interest income as a result of rising short-term interest rates during the quarter. And we saw good pickup from what we consider normal or other than prepayment related fee income for the quarter.

Marching through all the activity in yield this quarter and adjusting for the period-over-period changes from prepayment fees and rising short-term rates, I would say we are pleased with our lending business' ability to continue driving strong topline yield. There is no question that there is more liquidity in some of our markets and we continue to see pressure on spreads. However, we have proven that we have the ability to generate consistent strong yields in spite of these competitive forces.

Cost of funds increased in the quarter to 4.25% from 3.71% driven largely by increases in short-term interest rates. One-month LIBOR which we track as the best proxy for our funding costs, averaged 3.11% this quarter versus 2.64% in the first quarter, an increase of 47 basis points. Subtracting these two, our borrowing spread to LIBOR increased slightly this quarter to 114 basis points from 107 basis points in the first quarter.

Tom Fink will talk about our funding plans and certain transactions completed in the quarter, but let me summarize by saying that lower margins on credit facilities, negotiated during the quarter and the completion of our 2005-1 securitization were offset by a higher financing fees in the quarter including the accelerated amortization of deferred financing fees related to prepayments.

Net interest margin, or NIM, was up strongly this quarter to 9.18% from 8.52% in the first quarter reflecting mostly the increase in core and prepayment related fee income for this quarter. We were very pleased with this increase as we are with the strong yields in the quarter. But as we typically model only 50 basis points prepayment related fee income in our future forecast, we fully expect NIM to decrease next quarter back to the mid to low 8% area which is what we had forecast for the full year.

This reflects both the normal level of prepayment related fees and also the fact we are continuing to grow into our leverage which adds interest expense and mathematically lowers our net interest margin.

As John mentioned, credit provisions were lower this quarter based on our lower specific reserves and the continuing shift in mix of the portfolio toward more asset-based lending.

Moving away from the portfolio, let me comment on two other items from the results. Other income and our operating expenses. Other income was 5.7 million for the second quarter, up 1.4 million in the quarter compared to the previous quarter. This increase was led by a $1 million increase in income from our HUD agency business as well as some realized gains in dividends on or equity investments this quarter. These dividends and gains were approximately 3.2 million for the quarter.

The third component of other income, dead deal fees or due diligence deposits forfeited, were lower than the first quarter and expectations but these fees are lumpy and more of an accounting item than true income in that they have an almost dollar-per-dollar offset in operating expenses. As we have spoken about before, we consider all of other income to be recurring income that will be there from year-to-year but hard to forecast in terms of quarterly timing.

Last, operating expenses were up this quarter in dollars as you would expect from a growing business but also as a percent of assets. This flip up in terms of the percent is not a trend but more of a second-quarter phenomenon.

As we have discussed before, our employee bonus pool is linked to the profitability of our business. If we have a very good quarter for earnings as we did this quarter, we accrue a higher bonus expense. So, as we have said before in quarters when we have good results you should expect to see an increase in operating expense as a percent of assets.

Also during the quarter we signed employment agreements with our three lending business presidents. These agreements which we filed an 8-K for on April 8 had additional restricted stock that is more weighted toward vesting in the second quarter. We expect our third- and fourth-quarter expense related to these agreements to each be about $1.7 million less than the expense we incurred in the second quarter related to these agreements.

With that, I will turn the call over to Tom who will update you on our funding plan.

Tom Fink - *CapitalSource, Inc. - CFO*

Thank you, Jason. During the second quarter we continued our progress in further developing and improving our funding program. We started the quarter by closing our 2005-1 securitization which we talked about on the last earnings call. And since then we've added a new credit facility with J.P. Morgan which increased our financial flexibility and added to the breadth of our funding capabilities.

We also added a new participant, Bank of America, to our largest credit facility, increased the total size of that facility to $826 million, reduced the pricing and renewed that facility. Additionally, we made some other changes to our other credit facilities to reduce costs and improve funding capabilities.

Our total committed credit facility capacity is now $2.46 billion. In addition, to continuing to enhance our secured debt funding capabilities, our plan is to further broaden and diversify our funding sources. We made a big step in that direction this quarter with the filing of our application to start a Utah industrial bank. We issued a press release earlier about the filing of our application. That application has now been accepted as substantially complete by the FDIC in the state of Utah and we will begin working with them soon in their review of our application and look forward to starting the bank as soon as the end of the year.

The establishment of CapitalSource Bank would be an important new funding source for us allowing us to broaden our funding sources at very attractive levels.

Going forward, we will continue with our plan to further broaden and diversify our sources of funding. To that end we plan to sign -- excuse me -- to file a universal shelf registration statement that will cover a wide range of potential security.

And with that, I will turn the call back to John.

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

Okay, I think we are ready for some questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Josh Steiner, Lehman Brothers.

Josh Steiner - *Lehman Brothers - Analyst*

Thanks. Congratulations guys on a good quarter. Just a big picture question and then a couple small housekeeping items. Big picture, wondering about healthcare, obviously it grew extremely well during the quarter. I think you mentioned that there was a June acquisition. I was wondering if I could just get the size of that.

But bigger picture, do you expect that healthcare can and will continue to grow at this rate so that over time healthcare becomes, if you well, disproportionately larger than one-third of your portfolio? Is that possible to expect?

And just two real quick housekeeping items. One is, how many development officers do you have right now? And in terms of your top five exposures, not who are they, but could you give us an idea of whether they are asset-based or cash flow in nature and roughly what they are in terms of size? Thanks.

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

Sure. Just really three questions there, Josh, or four questions. The question about the portfolio acquisition, future trends in health care, a specific question on the number of development officers and then finally, some detail on the top exposures, what types of loans they are.

Let me get with the first question. We acquired the portfolio in June so it occurred toward the end of the quarter. And it was about $200 million. It has been a portfolio of loans all healthcare loans and we've been tracking it for almost a year. And the deal finally closed in June with a number of borrowers we've done business with in the past and we saw it is a really good opportunity to expand our franchise into that business. So that clearly contributed to a nice bump in healthcare this quarter.

As it relates to the size of the healthcare business in the future, you have to remember that the healthcare business, which I always refer to as the healthcare business is really the Healthcare and Specialty Finance business, and it had some non-healthcare businesses in it including business credit services which is our general asset-based lending business which is I talked about in the past. We are very excited about and that team is doing a great job and growing nicely and it also has our security alarm finance business. It is really a collection of specialty asset-based businesses of which healthcare is still the dominant part and I would expect it to be -- remain the dominant part.

I think that business will continue to grow and will -- I had said to some people that it wouldn't surprise me that it was our largest business by the end of the year. I probably knew it was already our largest business when I was saying that so I was able to say that with some confidence. But I expect it to stay the largest business throughout the year. I think we set the business up to be our largest business with the breadth of products that they have.

Now having said that, Corporate Finance which has been flat because of the competitive environment. But we do have Structured Finance which is kind of a nice steady grower and particularly with the progress that they are making on the real estate side, I would expect that to grow at a similar rate to healthcare across the rest of the year.

So I think a somewhat long-winded answer to your question, I think Healthcare and Specialty Finance will be the largest business but I don't think you should worry about it becoming our half the portfolio.

As it relates to the largest exposures in the Company. I'm looking at the list now. I won't disclose the names or the amounts because we don't disclose that. But I can say these are all asset-based financings either true asset-based receivables, stuff like that, or real estate. Which I think was your question. So the five largest exposures -- we manage our concentrations down based on what we consider the underlying risk level of the loan and we definitely -- are more comfortable holding an asset situation then a situation that is more underwritten based on the enterprise value of the business.

Now, as it relates to development officers. I'm going to answer the question but I want to put a little texture around it because we have people in the Company who do things other than -- who do things in the origination side but are not kind of labeled development officers. The total people that would be considered development officers is right now at about 23. But in addition to that, many of the investment officers and investment associates are actively involved in the origination side and we have 24 investment officers and 27 investment associates in addition to 22 investment directors.

So that whole kind of investment team, which is very much involved in new business and originations, the rough map here it looks like it's about 73. And we have an in-house marketing group which coordinates all the marketing for the Company which includes the 100 plus tradeshows we go to a year; all the print advertising; all the direct-mail and the telemarketing we do. So it's hard -- if you're getting at kind of the size of the origination machine and I don't know if that is what you are getting at -- but assuming you are getting at that, there's 23 people who are specifically charged with originations. Then we've got about 70 something people who are actively involved that side of the business, further supported by a robust in-house marketing group.

Josh Steiner - *Lehman Brothers - Analyst*

Great. If I could just ask one quick follow-up.

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

Sure.

Josh Steiner - *Lehman Brothers - Analyst*

It sounds like you guys have been able to find a fair number of these 100 to 200 million complementary acquisitions -- ?

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

We've done about five of them.

Josh Steiner - *Lehman Brothers - Analyst*

Right. They seem like they've been a nice complement to your organic growth. Do you see a fair number that are out there today so that going afford we could reasonably expect to see this continue to complement your growth?

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

When we talked about, I remember at our investor conference last year people said our 1.5 billion net guidance would that include a portfolio acquisition? And I believe I said yes because we do view it as part of the business. Most of what we're doing here is buying loans typically at par at some discount to par or at some slight premium. If we're buying a business like we did with the security loan finance business when the bought that, which was a portfolio acquisition, and then with the CIG business which was our mezzanine lending business which was a portfolio acquisition also. We also inherited a team with those, which is great. This acquisition, like others we've done have more been situations where we just bought the loans and absorbed them into the existing team.

You should expect us to be doing one or two of these a year and that has been built into our numbers in the way we look at the business. But there are generally things that are pretty close to what we are doing, very complementary, they kind of tuck in and they are generally things we track for some time like this portfolio. We've been tracking this for probably about a year.

Josh Steiner - *Lehman Brothers - Analyst*

Great, thank you.

Operator

Bob Napoli, Piper Jaffray.

Bob Napoli - *Piper Jaffray - Analyst*

Good afternoon, guys. A question, John, can you give me at some outlook or give us some outlook on some of the pieces of credit? I guess you reiterated your guidance essentially for specific reserves. I wondered if you could talk a little bit about what -- how you feel overall about credit and what would be the trends that you would expect to see in some of the buckets that people watch closely such as the non-accrual loans, delinquencies and impaired loans?

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

There's a couple things you have to keep in mind with these buckets and that is loans tend to stay in them for a while. For one or two reasons, either the workout strategy of the loans particular if it's a Corporate Finance loan tends to be a longer workout strategy. Unlike some of the asset-based stuff which generally goes in and out a little faster. And when I say asset-based, I mean the receivable lending business, things like that. Those tend to be pretty quick ins and outs into these buckets.

Things that are real estate related just because it we're foreclosing, the local laws may limit how quickly we can foreclose and things like that. They tend to be sticky and stay in the categories for a while. Or Corporate Finance deals which typically involve more of a business workout, either an organized sale of the business because it's having difficulties and they've hired an investment bank and they run an auction and they sell it. Or because there is actually a business turnaround that is going on and you need to kind of get some of the turnaround done before you can sell out it. So these things take longer.

So as some of these loans have added to the category this year which hadn't happened in prior years, which we expected to happen due to the normal season of the business. As they have come into the categories, we expect them to stay there and be a little sticky. Included in these definitionally impaired loans when they go in there the accounting dictates that they stay there for a year, so they won't come out. So I think our view is that some of these categories particularly non-accrual category, which is really the most relevant category in terms of how we look at it -- and I spent some time on that on the call making the point to people that it was really one new situation that moved it up in terms of a new problem situation.

I think it will trend up but I don't think they will trend up substantially. But I think you'll see some trending up in the non-accrual category.

Bob Napoli - *Piper Jaffray - Analyst*

Okay. And with regards to healthcare, CIT appears to be getting much more aggressive in that business. I was just wondering if you could talk a little bit about the competitive environment? Did you look at the acquisitions that they made? And are you more concerned competitively about your healthcare segment?

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

No, I'm not concerned. I mean our healthcare segment I think is doing about as well as it could possibly do. The team is executing at a very high level. I don't think there is any question that it is the best group in the business. We are not at all concerned about this acquisition. We don't really comment on things that we've look out, if you will. But we have a fully built out healthcare team that I think is the best in the business. So it would be unusual for us to need to hire or pay a premium for another business is the way I would look at it.

And we have competed with financial institutions with all kinds of scale and low-cost capital for a long time in the healthcare business, as you know, Bob. I mean G. E. Capital does a nice job in the healthcare business and we've been competing with them all the way back to my prior business with quite a bit of success. I think the situation you are referring to is a solid competitor in the market that kind of moved from one low-cost balance sheet to another low-cost balance sheet. And so we are not anticipating any significant change in the competitive environment based on that.

Bob Napoli - *Piper Jaffray - Analyst*

Thanks.

Operator

Moshe Orenbuch, Credit Suisse First Boston.

Moshe Orenbuch - *Credit Suisse First Boston - Analyst*

Thanks. I'm wondering if you could just give us a little more clarification on the expenses? Jason had mentioned that the expenses would be down 1.7 million in the third and fourth quarters. Was that kind of sequentially each quarter over the other? Is that just the vesting of the restricted stock or is there something else going on there?

Jason Fish - *CapitalSource, Inc. - President*

No, there is nothing else going on there, Moshe. What happened was when we set up the new restricted stock program for the three presidents there were basically you straight line those over the life except when you have a vesting. And so you had some immediate vesting at the time of the signing which is why you had a big accrual or a big expense item in the second quarter. You will then straight line it for the next three quarters and then you will have a vesting again in each subsequent second calendar quarter.

So you'll get a spike up. Now you won't see a spike up in the second quarter of '06 or further out like you did because the most substantial amount of vesting happened at the signature on the documents. So you will have basically for the next three quarters you will have the same amount of expense per quarter. And just from a quantifying amount, it is going to be about 800,000 a quarter.

Tom Fink - *CapitalSource, Inc. - CFO*

Moshe, this is Tom. If I can add one thing to that. I think what we were trying to explain there is obviously the operating expense as a percentage of assets flipped up this quarter to 3.22% and the point we're trying to make is we expect that percentage to go back down and continue its downward migration towards our long-term objective there.

Moshe Orenbuch - *Credit Suisse First Boston - Analyst*

Okay, thanks.

Operator

Michael Hodes, Goldman Sachs.

Michael Hodes - *Goldman Sachs - Analyst*

Hi, good afternoon guys. A couple of questions. First, just high level on credit, John, I was hoping you could give us a sense -- or maybe we could pin you down a little more specifically about where you'd expect some of these metrics to trend over the next six months or a year? If I look at delinquencies, non-accruals and impaired loans less the stuff in multiple categories, I think it was 1.5% in the fourth quarter, 3.5% in he first quarter and 3.9% in the second quarter. And on a year lag, it's like close to 6%. Should we be surprised if these metrics settle out? I don't know, 100, 200 basis points above where they are as the growth normalizes?

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

A lag analysis would indicate that. And when we gave our specific reserve guidance in our investor conference which we plan on updating, by the way, and our investor conference that is going to occur in September, we will have some new data on that and some new guidance around it. But we did the same kind of lag analysis that you are referring to, Michael, where if you looked at kind of the loss of the specific reserve slots/credit or charge-offs that occurred at the time when we did this in September of '04, and we kind of looked at those for '04 and we kind of constructed a hypothetical pool that would represent. You kind of had stabilized losses of about 70, 71 basis points which was what our first data pool indicated which we told the market.

And so if you assume that all charge-offs will go into non-accrual and if you assumed we have recoveries even if you say 75 basis points, you should assume non-accrual will certainly be at 3%, that would be a quick back of the envelope there.

So I would think we'd see some movement. Again, we don't think because of our view on what the ultimate losses will be, they'll move up appreciably. I can't pick a number. But I think the other thing that is going to happen is the portfolio mix is changing moving more toward asset base. I think that will start having a factor too on how these metrics appear because you get fewer sticky non-accruals. What you get in the asset-based stuff, things go in and out but you don't get these sticky non-accruals which cause them to build up.

So I think that will have a factor on where that settles in also. But a lag analysis would indicate they should be higher. But the recovery statistics still indicate that the charge-offs, which is the real driver here because it gets to the profitability of the business, should be in line even with some increases in the non-accruals.

Michael Hodes - *Goldman Sachs - Analyst*

Just a clarification, I think you indicated that the bulk of the jump in non-accruals was one specific situation. Am I inferring properly that one loan was $42 million went into non-accrual?

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

No, let me go over that. It was one new situation but let me go through that one more time what happened there. If you look at the non-accrual situation, if you go from March to June, two new situations went in. Okay? One real estate loan with a specific reserve, okay. And one corporate finance loan that was impaired so it's not really new, it's new to non-accrual but it's not a new problem loan and it has a specific reserve against it. So those two things slid in. One was a brand-new situation that just appeared this quarter and one was a problem situation that just hadn't migrated to non-accrual yet.

And so those were the two new situations. We lost a situation because we charged off a loan that we'd been working out, a corporate finance deal that has been bouncing through these categories for the last year. We finally fully resolved. We charged it off. There's a little tiny piece left of it that's kind of an associate -- or an affiliate loan, if you will -- but it is pretty inconsequential. So I can't say it's all charged off but it is substantially materially charged off.

So two went in, one brand-new situation, one migrating from another category and one went out. And now the math you are showing indicates that if that is true, then that one loan is large. But what also happened as we had a problem situation in the corporate finance group where we have an asset-based revolver and the term loan that has been in these categories. We elected to buy out our co-lender in the asset-based revolver which is a fully secured part of the capital structure. But with the borrowers in the problem category, we put the whole loan in the category even if the asset-based loan is money good. Do you see what I mean?

So we bought out our co-lender there at a small discount so that caused that loan to grow. And that is really what caused it to grow as much as it did. Do you see what I mean? So that is why it is really one new situation, that new real estate loan with a specific reserve on it.

Michael Hodes - *Goldman Sachs - Analyst*

I got you. I appreciate the detail on credit. Just two other questions if I may. In terms of the level of churn in the portfolio, I know you are reluctant to give us gross originations but it strikes me on a net basis absent the healthcare business, this was one of the lighter net growth portfolios you've had since you've come -- net growth quarters since you've become public. And just given the size of the prepayment penalties, I was hoping maybe you could give us a flavor of whether those prepayments penalties were dominated by one or two situations with very heavy prepayment levels or there was actually a substantial amount of loans that prepaid?

Jason Fish - *CapitalSource, Inc. - President*

It's Jason here. Michael, as I had said in my remarks that we had, we did have large prepayment fees and they were associated with larger than normal prepayments for the quarter. So I'd say that our gross originations were very strong across the board even without the acquisition of the healthcare real estate portfolio that John spoke about. And we did have abnormally large prepayments primarily in the corporate finance area for the quarter.

So I don't think you can anticipate that kind of roll off going forward. But that was the reason why as you accurately say on a net origination basis, it was less.

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

(multiple speakers). They were no big loans that paid off, just a bunch of loans paid off.

Michael Hodes - *Goldman Sachs - Analyst*

Just lastly, in terms of the bank. Is that going to alter your thoughts on leverage as we roll into '06 and we get continued growth, how are you thinking about capital and potentially raising equity?

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

I don't think at this point the bank will change our view on leverage because we don't know enough about it. If we get to the bank functional and it becomes 20% of our balance sheet which we roughly said it could and it proves to be a very stable and predictable source of funding and that coupled with the other sources of funding make us feel that the funding picture of the Company is stronger, all of that together could change our view on leverage. And therefore the bank would be a part of that.

But I don't think we are ready to say that at this point. In large part, because we don't have the bank yet and we don't -- we have a very experienced and skilled bank president that we've hired and we've done a tremendous amount of work on it as you expect. But you don't really know it until you a have it. And so I think that would contribute to it.

Where the bank is useful, is as you see as our mix of business is changing more towards that space, which most people would say you can lever more because of the risk profile of the business. The bank is a great addition to help fund that business. So it's a lot of factors that would contribute to us increasing our leverage, probably more of the underlying asset quality than the leverage that is available to us, because we think leverage should be in large part driven by what is the right amount of leverage to put on the assets as opposed to what you can get. I think as we have more of an asset-based portfolio, you could argue that we could leverage that business more.

Michael Hodes - *Goldman Sachs - Analyst*

Thanks a lot.

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

Sure.

Operator

Don Destino, GMP Securities.

Don Destino - *JMP Securities - Analyst*

One more question about credit. John, as you look back over the last two quarters, and I realize that there was really not a whole lot of new situation in the problem loan category this quarter. Over the last two quarters if you look at what has gone sideways, are there any common threads? I mean are there any industries or geographies? Are they things that as you go back and look at your diligence, things that you thought you maybe should have caught, was there anything that is common among them or among most of them?

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

Well, I think the common -- I mean if you break our business down into buckets, asset-based real estate and corporate finance, I think we can say that we see very little asset-based deals really moving into those categories. And we see corporate finance and real estate deals moving in, which makes sense because even though a real estate loan is an asset-based loan, it is somewhat

an enterprise value loan because your ability to liquidate the asset is depending upon how it is doing. So you have a little more market risk. So both of those types of loans have market risk, but further you have operational risk in the corporate finance business. And I would say that is probably the area that I wouldn't necessarily say that there were misses in underwriting, but I think what happens if you have operational missteps by management teams that cause most of our problems.

The other thing that is interesting that I wouldn't draw any conclusion with respect to, but we think about it ourselves, one of the things we've noticed that some of the deals we've had problems with in corporate finance were the deals that had the best credit statistics going in and the best capital structures. In other words, the debt to EBITDA was fairly low and the amount of equity in the deal was fairly high. And we've just found that interesting that those are the deals that have caused us more problems -- or, you know, not caused us more problems, but if you look at the problem loans, some of them had the better capital structures going in. And I would say all that informs us with respect to is management is really important in these situations, and you can't take comfort in growing in EBITDA or your capital structure as much. But there is no common theme other than just those kinds of observations.

Don Destino - *JMP Securities - Analyst*

Got it, thank you very much.

Operator

Joel Houck, Wachovia Securities.

Joel Houck - *Wachovia - Analyst*

Thanks. Jason, what was the impetus for the restrictive stock? I seem to recall that you guys had locked up key people before second quarter of this year?

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

We might have talked about it.

Jason Fish - *CapitalSource, Inc. - President*

We talked about it. It was just a conclusion of the agreements, Joel. So we had talked about before in terms of locking people, and we just hadn't -- we'd locked them in in terms of oral agreements, but we finally got the documents signed in the second quarter.

Joel Houck - *Wachovia - Analyst*

Okay. You say there's a substantial portion to vest at the signing; that sounds a little unusual. Is that common in your business or what is going on with that?

Tom Fink - *CapitalSource, Inc. - CFO*

Joel, this is Tom. I mean these are multiyear agreement with vesting and granted over multiple years. I think the only thing that is unusual about it is that it's not straight line. There was a little bit off more of a weighting toward the second quarter relative to the third and forth and the first quarter so that when you kind of lay that out on a annual basis it looks normal. But the

distribution among the quarters is a little unusual because it sort of pairs up with the vesting schedule. SO that is why there was a blip up in the second quarter. And then the third and fourth quarter will be much lower. We'd expect to see that same phenomenon next quarter but obviously it would be next year as well but to a little bit less of a degree.

Joel Houck - *Wachovia - Analyst*

Okay. It looks like you got a little bit about one billion of capacity left in the revolver. I mean how far do you think you can get into that before looking to do another securitization?

Tom Fink - *CapitalSource, Inc. - CFO*

Our general plans are to do -- historically we've done two securitizations a year, I don't know what I can comment about our future plans for specific offerings. We will do one eventually.

Joel Houck - *Wachovia - Analyst*

Okay. And then I didn't catch the dollar amount of growth in structured finance. I know you said it was up 10%. Do you had a dollar figure?

Tom Fink - *CapitalSource, Inc. - CFO*

Yes, structured finance was up about $155 million roughly quarter-over-quarter.

Joel Houck - *Wachovia - Analyst*

Okay. Thanks.

Operator

Stephen Schulz, KBW.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Hi, guys. Thanks. Can you, I guess two quick ones. One on contribution of bonus income in the comp expense and how many employees were added in the quarter? And then as a follow-up to the level of deferred compensation costs on the balance sheet, it's up to about 66 million, it's up from 19 million at the end of last year. And can you talk about over what time period would you normally expect to recognize that deferred comp expense through the income statement?

Tom Fink - *CapitalSource, Inc. - CFO*

Why don't we start with the last question first. I think the recognition of the deferred comp expense is over a multiple year period. I would say between four and five years on an average is probably what to expect there. We ended the quarter with 439 employees, which is up I think about 35 or so people. I'll look for that exact number for you, I just don't recall it off the top of my head.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Okay. And then I guess just lastly, you had mentioned that on the cash flow loans that you have recognized losses on to date you've had about an 80% recovery rate which is pretty exceptional. I definitely would agree. You'd mentioned that the one corp FIN loan that you did take a loss on in the quarter you had about a 61% recovery rate. I was just curious can you comment on whether that lower recovery rate just had to do with market conditions or whether it had to do with something specific to that loan?

Jason Fish - *CapitalSource, Inc. - President*

This is Jason. That loan had a very specific reason for it. I'd say with all of our other businesses that have fallen into the corporate finance troubled loan area, as John said, most of those have been some sort of a miscalculation on the part of management. In this case it was a business that was a regulated business and the regulator actually shut it down. It was a highly unusual circumstance that nobody really could have foreseen. So it was, I would say, a real exception to what to the rest of the pool looks like and that is why the recovery -- we were able to force the regulator to reopen it and then the asset was sold. And that is why we were able to get as good a recovery as we were. But it was really a very exceptional situation there.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Okay.

Jason Fish - *CapitalSource, Inc. - President*

But you have lower recoveries in the corporate finance loans generally.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

I understand that.

Jason Fish - *CapitalSource, Inc. - President*

Yes.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

When you say that was in a regulated business? Are we to understand it's a lending business?

Jason Fish - *CapitalSource, Inc. - President*

No, it was in the waste management business.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Thank you very much.

Jason Fish - *CapitalSource, Inc. - President*

So it was a -- you know it had a regulatory issue with one of its locations which turned it into a really bad loan. And so that is why the recoveries were so bad.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Thanks a lot for the color.

Operator

Laura Kaster, Sandler O'Neill.

Laura Kaster - *Sandler O'Neill - Analyst*

Thank you. Can you guys just speak a little bit to the competitive landscape that you've seen in corporate finance? And in what specific areas you are seeing it if it is in the due diligence or the amount of leverage given and the players that you are seeing that from? Has anything changed in that regard relative to your update last quarter?

And can you also please give an update on the reimbursement situation in Medicaid?

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

Sure.

Laura Kaster - *Sandler O'Neill - Analyst*

Thank you.

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

As it relates to corporate finance, I mean, if this was a less serious environment I would say we are seeing competition everywhere and every way. And what I mean by that is people are competing with us on price; people are competing with us on leverage multiples. And people are in fact competing with us on diligence. In other words doing no diligence, making it an effortless process for the borrower and the sponsor. It's just a very liquid market right now which causes two things to happen in our corporate finance business.

One it causes us -- because we think we are very selective and we try to have these very high credit standards -- it causes us not to originate as much as we have in the past but further, it has driven up multiples in that business so that really a large percentage of our portfolio companies are for sale because the people who own them are recognizing that buyers are paying very high prices for business right now. And because they are getting a fair amount of leverage.

And so we're getting the competition as it does in that business because as we said in the past has been our most cyclical -- will be our most cyclical business because of the flow of credit in and out of that business. Right now the credit is flowing in; lenders are feeling very bullish about financing LBOs at height multiples; buy out funds are feeling very bullish about buying businesses at high multiples. So we get a lot of portfolio sales out of our portfolio where companies are being sold. And then it is more competitive in booking the business which doesn't mean we can't find new business because it is far from an efficient market.

And we find many things to do and we've got a big reach in the business and teams are working really hard in finding good situations. But it is much more competitive then it was.

So, that is what is going on in that situation. And he Medicaid update, I mean, Medicaid is a state specific program as you know. So it is hard to give a general update on Medicaid. We are not seeing tremendous pressure on Medicaid budget affecting the assets that we finance the most which are nursing homes in terms of asset that are reimbursed by Medicaid. There is some state specific stuff going on but there is no large trend that we are most concerned with.

Laura Kaster - *Sandler O'Neill - Analyst*

Okay thank you. Just one final thing just so I'm on the same page. You've not changed any of your previously given guidance that you have given as over the last quarter?

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

No.

Laura Kaster - *Sandler O'Neill - Analyst*

Okay, great. Thank you.

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

Just to add to add that further. It's been our policy to provide annual guidance which will do in September.

Laura Kaster - *Sandler O'Neill - Analyst*

Thank you.

Operator

Kyle Cerminara, T. Rowe Price.

Kyle Cerminara - *T.Rowe Price - Analyst*

Thanks for taking my call. I had a question. At the beginning of the call you said that credit was generally in line with your expectations. I think you said something along those lines last quarter yet the stock price was down pretty significantly after the quarter. I'm just trying to get a sense where it seems like your expectations of what your credit will be in relation to your earnings guidance? And your forward-looking statements seem pretty consistent with what you've been thinking internally. But the market's expectations may have been different the last quarter and that maybe it wasn't explained well.

I guess just maybe if we could walk through some of the factors that contributed. One, like what is your current thinking on some of these non-accruals, the impaired loans? Maybe not as specific as that but just talking through sort of how they are consistent with your previous expectations?

And then what are some of the factors, you know, is it the economy, is it M&A? And you mentioned that some of your companies may be for sale that are in your portfolio. You know, oil prices at 60, is that impacting it? Is it GDP growth? Maybe we could just

walk through some of the things and certainly there it is lots of portfolio companies so you don't need to drill into each one but I just wanted to get a sense for overall what are some of the things that you are seeing that are impacting credit quality? And were those pretty similar or how did they differ from your expectations?

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

Yes, I think that is a really good point, Kyle. Because we talked extensively about this after the last quarter's earnings release where we maintain that the business was performing as we expected and people were certainly surprised with the credit metrics. And as we said back then, I'll say again now, I think we have to take some responsibility for not communicating some of this stuff as clearly as we should have. We spent a lot of time communicating that we expected the business to have credit losses because there was a sense early on that the business would run without credit losses. And I think we spent a lot of time on that and we didn't spend as much time talking about where these metrics would move.

And in fact if you look at some of the early quarters, we had reserves significantly, we had reserves when we would have no non-accruals, for example. And obviously we didn't expect that to continue or we wouldn't be reserving, or we wouldn't be saying we'd have charge-offs if non-accruals would stay at zero.

So I think that there was -- the communication probably wasn't done as well as it should and I think explains the difference between what the market thought and what we think because we clearly expect to have losses. We think losses will appear first in non-accruals and these loans will be a mix of real estate, asset-based and cash flow loans to varying degrees of recoveries, higher recoveries on asset-based and on cash flow with real estate recoveries probably somewhere in the middle.

What is causing us to have these problem loans -- we haven't -- there is nothing we can point to specifically other than from time to time mistakes in underwriting which we have made in certain situations when we look back and we said we shouldn't have made the loan. But that's, we try to eliminate that obviously but we will make mistakes. We've got well over 500 loans in the portfolio; it's fairly rare, we have a very rigorous process. We have this dual track underwriting. We have lots of people touching every deal and a fairly transparent process. We don't delegate credit authority other than to the credit committee. So we've created all these things, all these steps to deliver as good a credit outcome as possible but it is not perfect and mistakes are made from time to time. We think very infrequently. But some of our problems have been mistakes and underwriting.

Other problems that have just been things that we could not have predicted. And when we look back as we do and you would if you were in our business, when you have a bad loan -- you are like, okay, what did we do wrong. If we look back and say well based on everything we could have known at the time there is really -- we don't really find any mistake in the underwriting. There is just a mistake in the management of the business. And perhaps we should have been able to anticipate that more but sometimes managers and the people who own businesses do things to companies that they shouldn't do or run businesses the way they shouldn't run them and it causes them to lose large customers or causes them to misprice their product or do other things that causes the business to have distress.

But we haven't seen things like the price of oil or interest rates or any of those things -- I mean, we underwrite our businesses to tolerate those type of things. What is sometimes harder to underwrite particularly in the corporate finance business is really bad mistakes that management teams may make. Because there's obviously not as much tolerance for some of that stuff. So we haven't been able to point to any kind of common thread. I don't know if that gets to the question.

Joel Houck - *Wachovia - Analyst*

Absolutely. I guess the important conclusion is that none of what you've seen in this quarter and nothing what you told us last quarter in terms up credit impacts $1.45 guidance in 2005 or your outlook for growth beyond that?

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

No, as we've said I mean we feel confident with our -- we reiterated our guidance that we've given this year. We only give a new guidance so we haven't made any comments about '06 yet and I don't want to do that now because we're going to do that in September. We stand behind our guidance.

Kyle Cerminara - *T.Rowe Price - Analyst*

Great. In terms of reserve levels you feel very comfortable with your reserve levels?

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

We do feel comfortable with our reserve levels. As we said in the past, as in new business, the best way to judge what your reserves should be is to have years and years of data, certain businesses and certain financial institutions that had been around for 20, 30, 40 years have lots of data and larger more diverse pools or portfolios than we do. And so their ability to sit there and pound the table and say their reserves are accurate because their methodology that's been applied across 20 or 30 years has always indicated this result.

We in fairness can't do that. We're a younger business and we are only starting to get the data. And as we promised last September, we intend every year to look hard at our reserve methodology, to look hard at our specific reserve guidance and update that as information presents itself. And we're actually in the process right now of taking the recovery data we have, taking some of the trends in the portfolio and trying to test our reserves so that when we stand in front of investors and our analysts in September, we can give new guidance and say that we've rerun all the tests that we ran last year.

So we feel good about our reserves now based on the information that we have. But it is likely to move around year-to-year based on new information. I think if you lift up and you look at this business and its style of lending we employ, which is -- what is our current percent, Tom -- 94% senior secured -- and what is our mezzanine? 94% senior secured, large weighting in asset-based, large first mortgage portfolio and even on the cash flow side which are riskier loans, our senior secured, we have to lean on all the assets and if you go around and look at other lenders who have been in this business or lending groups within banks that have been in this business and you start pulling out some of the credit statistics, you'll see that the kind of numbers that the (indiscernible) sources are talking about is certainly in line.

And we plan on having some of that data too in September. So I think the message on the reserves we feel good about them. Every year we're going to work harder on updating them based on real information and more information that we get. And if you lift up further you can see lots of comparables that kind of support the numbers we are talking about.

Kyle Cerminara - *T.Rowe Price - Analyst*

And last question, I guess given your position on these loans and that your senior secured and given that there is a workout process and given that you can restructure these loans and there is the potential that some of the companies that may be on non-accrual, may be for sale or maybe --

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

Right.

Kyle Cerminara - *T.Rowe Price - Analyst*

-- end up -- you may get out like almost $1.00 on your $1.00; $0.98 on the dollar and so on. And I guess while the absolute dollar amount of the loan that may be on non-accrual or impaired may be larger, you're absolute loss exposure may be much less?

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

Absolutely. And that is why we try to give the recovery statistics. Quite frankly I think our recovery in asset-based should trend up towards 100. My experience in asset-based lending in the healthcare side going back now ten years has been 100% recoveries. So we should have very high recoveries on the asset-based side. Recoveries should be strong on the real estate side. We're a first mortgage lender, lending against real assets, real property, some of which is being repositioned so it is not without risk. But there is a good underlying fundamental value that recoveries should be there.

On the cash flow side, we should have very strong recoveries. The real risk on the loss in the recovery side was early on and over time goes away because there is the potential that every -- just like the cicada bug -- every 17 years you get a really bad loan that pops up that you get a zero on. Like a bunch of lenders made a loan to Arthur Anderson right before the government put them out of business and they ended up with a zero. There are things that happen that you can't predict when you make enterprise value loans and you get really, really bad recoveries.

That will probably happen to us one day. Hopefully it will happen way in the future when the portfolio is really big and the lumpiness of some of these loans has gone away because as the portfolio gets bigger and our average loan sizes don't change, the likelihood of one of these really bad situations that could happened materially affecting our results goes down.

But my view is that the corporate finance loan should demonstrate very strong recoveries because we've underwritten real businesses that have had years of profitability, that someone paid lot of money for and have assets that we have the first lien on. So you have to come up with some pretty odd situations where we get really low recoveries. I think the 61% recovery that we had in this one situation, I think that is a really bad recovery. We are not happy about that. And we consider that a really bad recovery and it is 61%.

So -- I think your point is will we have good recoveries on these loans, I think the answer is yes.

Kyle Cerminara - *T.Rowe Price - Analyst*

I appreciate you taking my call and thanks for hosting the call.

Operator

Craig Maurer, Fulcrum.

Craig Maurer - *Fulcrum Global Partners - Analyst*

Good afternoon. I was hoping you can focus on interest income for a second and talk about what you expect for the rest of the year ex the fees, just what you are saying on the interest income line? I noticed you cited an increase in your cost of funds. What was the real net interest margin in the quarter ex fees and what are your expectations for the year? Thanks.

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

We're just trying to pull the direct numbers for you.

Craig Maurer - *Fulcrum Global Partners - Analyst*

Okay, thank you.

Tom Fink - *CapitalSource, Inc. - CFO*

Craig, its Tom Fink. Let me say a couple of things. One, there have been increases in short-term rates and we're expecting future increases in short-term rates if you try to equate a yield if you will to a lending spread. And I will say also that we also look at fees as being an integral part of our interest and fee income together because many loan situations there is some flexibility around interest income component or fee component. And we are relatively indifferent between those two.

If you do look at -- break down those spread components in the quarter we saw interest rates rise, short-term rates rise about 47 basis points. Our core fees, if you will, that's fees minus the prepayment related fees actually increased 18 basis points quarter-over-quarter. And the coupon component of interest income shrank 16 basis points. That shrinkage can be due to a member of things part of it the trade off between fees and income, interest income that we have. There can the issues between prime and LIBOR, basis risk, the changing asset mix in the business, where asset-based loans could have lower spreads than other types of loans for example.

And also just as we've talked about, the effect of competition and the increases -- the pressure that that can put on a spread. So I think balancing all those things like Jason said, we are very pleased with the business' ability to continue to generate strong risk-adjusted spreads in the portfolio.

Craig Maurer - *Fulcrum Global Partners - Analyst*

So as you continue to add asset-based loans, essentially it sounds like the fee portion will pick up while perhaps the actual coupon portion might slow down a bit?

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

Yes, I think that is right directionally.

Craig Maurer - *Fulcrum Global Partners - Analyst*

Okay. Thank you very much.

Operator

Jason Stewart, Friedman, Billings, Ramsey.

Mike Turner - *Friedman Billings Ramsey - Analyst*

Good evening, thanks. This is actually Mike Turner in for Jason. All of my questions have been answered just except for one. I just wanted to find out what if any impact there would have been on yield in the quarter due to restructured loans?

Tom Fink - *CapitalSource, Inc. - CFO*

I don't think there was any measurable impact to yield based on restructured loans.

Mike Turner - *Friedman Billings Ramsey - Analyst*

Okay. That is all I had.

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

One point worth making that I think -- the loans in our problem loan list many if not the majority of them are paying current interest even if we have them on non-accrual.

Mike Turner - *Friedman Billings Ramsey - Analyst*

Okay. Great, thank you, guys.

Operator

Bob Napoli, Piper Jaffray.

Bob Napoli - *Piper Jaffray - Analyst*

A couple quick questions I hope. In corporate finance is the competition, if you're looking at that sector, is the competition less on smaller loans or is it across the board on the loan size? As you guys start getting down to your 7, 8, $10 million loan, is that a lot less competitive than your 10 to $20 million loan?

Jason Fish - *CapitalSource, Inc. - President*

I would say that we are finding that there is less competition the smaller you go in loan size, Bob.

Bob Napoli - *Piper Jaffray - Analyst*

Would we see your loan sizes gravitate downward given that?

Jason Fish - *CapitalSource, Inc. - President*

I think that is a reasonable expectation.

Bob Napoli - *Piper Jaffray - Analyst*

Okay. Then on your impaired loans and I know we focused a lot of the discussion today has been focused on the non-accruals and delinquents. But it is a lot focus -- the impaired loan is a big number and you use the term definitionally impaired. I was wondering if you could give some examples of loans from an accounting standpoint that need to be in the impaired loan category yet you clearly feel that there is very little risk in those loans? If you could give some of the examples?

Jason Fish - *CapitalSource, Inc. - President*

Probably the best example we can't it is a loan that would be classified as a troubled debt restructuring. We have those, a couple in the portfolio where the loan gets into trouble, you recast the loan, it doesn't impair your ability to collect interest and principle over the life but you change perhaps the payment schedule on it in order to facilitate an easing of perhaps a short-term credit squeeze on the part of the borrower.

Once that loan is fully performing and restructured, we have to keep that loan in the impaired bucket for up to a year. So we have at least one situation in the impaired bucket now that has been restructured and been fully performing and without interruption. But it still has probably three quarters to go in that bucket.

Bob Napoli - *Piper Jaffray - Analyst*

Does that make up -- does that type of a situation made up a major chunk of the impaired loans?

Jason Fish - *CapitalSource, Inc. - President*

It is not a major point right now but as we work through these loans where you don't see companies getting sold or assets getting sold. I think you'll see that component getting larger, yes.

Tom Fink - *CapitalSource, Inc. - CFO*

And to Jason's points, Bob, I mean some of the finer points of the accounting on this is that basically when you make the determination that a loan is impaired, it is impaired forever, for the rest of its life in our portfolio until it pays off. Or until it is restructured pursuant to a troubled debt restructuring that Jason talked about. And then the rules are that it remains cost divided (ph) impaired for twelve months. And if it is performing at the end of twelve months then it can come out of the impaired bucket.

So it -- as we go on and as the portfolio seasons, I think we will be collecting things in the impairment bucket and we will just have to be as clear as we can in trying to explain -- show everyone what is there.

Bob Napoli - *Piper Jaffray - Analyst*

And then on the operating expenses, can you remind me what your goal is for the operating expenses as a percentage of loans for 2005? Your guidance?

Jason Fish - *CapitalSource, Inc. - President*

2.7%.

Bob Napoli - *Piper Jaffray - Analyst*

2.7% and you are still comfortable with that?

Jason Fish - *CapitalSource, Inc. - President*

Yes.

Bob Napoli - *Piper Jaffray - Analyst*

For the full year?

Jason Fish - *CapitalSource, Inc. - President*

Yes we are.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you, I appreciate the detailed credit discussion.

Operator

Ladies and gentlemen, this does conclude the question-and-answer portion of today's conference call. I'd like to turn the call over to Mr. John Delaney for closing remarks.

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

I just want to thank everyone for joining us and remind people that we will -- I referred to this earlier -- we will be sending out invitations for our investor conference which will be on September 21 in Washington D.C. Some more to come on that. I wanted to take this opportunity to remind everyone of that and thank you again for calling in.

Operator

Ladies and gentlemen, thank you for your participation in today's conference call. This does conclude your presentation. You may now disconnect. Good day.
