MANAGEMENT DISCUSSION SECTION

Kurt Hoffman, Imperial Capital, Analyst

Good morning. I'm Kurt Hoffman, desk analyst with Imperial. We are really happy to have CapitalSource here this morning. I'm going to turn it over to Jim Pieczynski, CEO. Thank you, Jim.

James J. Pieczynski, Co-Chief Executive Officer

Thank you, Kurt, and thanks, everybody, for joining. Today, I'm going to give a presentation on CapitalSource and we're a company that's in a transformation period. And I'm going to go over kind of our key messages, talk about our bank, which is where we're funding all of our loans out of, also focus on the parent, which is -- because we have a parent that's winding down, go through our credit statistics, our year-to-date accomplishments and then ultimately the investment thesis surrounding our company.

In terms of looking at our company, we believe we're a company that's built for long-term success. Since its founding, CapitalSource has been a balance sheet lender. All the loans that we do have been on balance sheet loans, and we intend to continue doing that.

We also think one of the things that separates us out is our specialty business line. We basically have 12 different lending platforms and it's because of the specialty niches that we have, we think that is what differentiates us from a traditional banking model.

In terms of our source of funding, we have a California depository-based institution, CapitalSource Bank. It's a de novo bank that was formed in July of 2008, and we have been using that largely as our vehicle for funding of new loans. So we believe when we take our depositary franchise along with our national origination platform, that's what differentiates us from a traditional regional bank.

In terms of the second quarter and our messages, our second quarter was -- indicated a return to profitability. We were profitable on a consolidated basis and at the bank, and we expect that we have now turned the corner. We have stabilized our credit issues and we are now moving forward and expect to be profitable going forward.

Supplementing that was our cost of funds at CapitalSource Bank has declined. Our current source of funding is less than 1.5%. We obviously think that's probably about as low as it can get, but that is -- we are clearly having the advantages of a low cost funding source.

Our loan growth is starting to pick up. During our second quarter, we had $441 million of new originations. We've communicated to the Street that we will be doing an average run rate of 300 million to $400 million per quarter, and that's clearly in excess of where we've been at the past.

Our liquidity at the parent has improved significantly. We have $376 million of cash at the parent company. We don't have any more maturing debt in 2010 and the next level of maturing debt that we have is our converts in 2011, and we believe that our credit has stabilized.

And if you look at our loans on non-accrual status, that number has basically stabilized. It declined slightly from where it was in the first quarter and our delinquencies on a total basis also slightly declined.

Focusing on the bank, the bank is based in California. We are a de novo bank formed in 2008. Our branches -- we have 21 branches that are largely located in Southern and Central California. The bank is a $5.8 billion asset size. Our commercial loan portfolio is $3.5 billion. Our deposits are just

over 4.5 billion. And we think one of the things that differentiates us is if you look at the branch network that we have, our 21 branches average roughly $220 million of deposits and we're able to run those with approximately six FTEs per branch. So, again, we consider that a very efficient funding source for us.

In terms of our strategy, our strategy has not changed from what we have done before relative to originations. We provide financing to small and middle-market sized companies. We have done investments for both growth, acquisitions, as well as replacing existing capital needs. We have a direct national origination platform. We have offices located throughout the United States. All of our loans are, however, funded throughout the bank.

We have maintained very, very much a focus on our specialized industries. That's been largely healthcare, security, technology and lender finance. And we think that is one of the things that very much differentiates us from other banks that are out there. In addition to that, we've added in some new product lines this year, which is our corporate asset finance group, our professional practice group, and our SBA lending.

We've also coupled this with doing multi-family lending in Southern California. All of our loans are originated in-house. In addition to having an origination team that is largely there from a business development perspective, we also have an in-house underwriting group that operates separate and apart from our origination group so that we have another check on the loans that we're looking at.

Let's turn to our funded loan growth, I talked about this. Our growth during the – our loans originated during the second quarter were $440 million which is significantly higher than what we've done in any of our previous quarters. And we expect that – as I said, we have kind of guided the Street to $300 million to $400 million of new originations each quarter.

In terms of our portfolio, one of the things that investors have been asking us about is what does our portfolio look like between our legacy portfolio and loans that have been originated at the bank. Our total portfolio is roughly $3.5 billion. 1.8 billion of that is our legacy portfolio, i.e. these are loans that were originated at the parent and transferred to the bank in connection with its initial formation. And then we have another 1.7 billion that has been originated at the bank. And again, you see the grouping as to how our assets have been funded.

If you look at the last three, the multifamily, the corporate asset finance and the SBA, those are new lending lines that we've started. We started getting involved in the multifamily business last year. We have started the corporate asset finance business this year along with SBA. We acquired a SBA lender, MainStreet was the name of the lender. We've brought in that platform. We've hired all the people from that company and have started our own SBA lending group and we're able to fund those loans at the bank.

The Corporate Asset Finance Group is a similar group where again we brought in a group that is focused on this, they've had experience in it, they've done it for the last 20 years, and we brought in that expertise to round out our offerings.

One of the big things is if you look at this, the asset shift from our company is very strongly going toward the bank. And if you look at the blue line, that's the level of parent company loans that we have and quite frankly, the parent company loans are in more of a runoff mode where as those loans are maturing, as they're paying off, we're using those proceeds to pay down either our credit facilities that are outstanding or the securitizations that we have outstanding.

On the other side if you look at the green line, that's our bank loans and you see that our bank loan growth has been steadily increasing. And one of the things that we expect now with our origination platforms really rounded out and having a lot of momentum, we expect the bank asset growth to continue at a much higher pace than what we're seeing here.

In addition to that, we've had healthy spreads. If you look at the yield on our interest-earning assets, that number has stayed relatively constant; however, we've had the benefit of the declining cost of funds dropping from 3.5% in the fourth quarter of 2008 to below 1.4% in the second quarter of this year. So we think with that we've been able to maintain healthy investment margins and we expect that to continue going forward.

Again, the other thing that's nice to point out is even though we have had a declining cost of deposits, if you look at our deposit trends in the back end, 2009 because of the fact that had a lot of liquidity, we were consciously letting our deposit flows go away because quite frankly, we didn't need the liquidity associated with it. You see some of that starting to come back toward the end of 2009 and basically in 2010, it stayed relatively constant.

If you look at our deposit base, we're at roughly $4.5 billion right now. The existing branch network that we have has the capability and has been as high as $8.5 billion of deposits before. So we view that the branch network as kind of one of our underappreciated assets where although we've only got $4.5 billion of deposits right now, there's significant growth opportunities that are there for that deposit base.

Again, our bank is a very well capitalized bank. If you look at as a -- on a risk-based capital ratio basis, we're at 17.7%, which is significantly above what is considered to be a well-capitalized bank at 10%, and no matter what peer group you compare us to, we're clearly in excess of that. The same holds true for our tangible common equity as a percent of tangible assets. We have roughly 12.5%, again clearly above any of our peers and significantly in excess of the standards for what is deemed to be well capitalized.

Our expense ratio has also been up. We've been operating very, very efficiently at the bank and we expect this is a number that will get better. One of the things that's different when you look at our bank is that our bank is paying the parent an origination fee for new loans that are being done at the bank. So the way the structure works is that the bank pays to the parent 1.5% of new commitments that are originated by the bank and the bank includes those numbers in their cost structure. So when you look at the bank, this includes the fee that is being paid to the parent.

If you look at the bank's infrastructure, the bank's infrastructure is largely filled out and because of the fact that we have the ability to grow and grow our portfolio significantly at the bank with its existing infrastructure, we expect that our expense ratios are going to continue to decline as time goes on.

Looking at our credit trends, I think the second quarter for us was a significant event at the bank. The bank's loan loss provision for the second quarter was $5 million. On a consolidated basis, we were at roughly $25 million but the bank's portion of the loan loss provision was $5 million.

Again if you look at our allowance for loan losses at the bank, we're just under 5% of our loans, which again if you compare that to other peers that are out there, we believe that the loan loss reserve that we have is significant and adequate.

If you look at our delinquencies, you'll see between all of the loans that we have delinquent at the bank, we have roughly $79 million of delinquent loans at the bank. That's up slightly from where we were in the first quarter. However, a large part of that is the function of us acquiring the MainStreet lender, which had an SBA portfolio where there were delinquencies built into that.

So if you adjust for the elimination of the MainStreet portfolio, basically our delinquency numbers at the bank have stayed approximately the same. And then we've had a slight uptick in non-accrual loans at the bank but again, when you look at it on a consolidated basis, we've actually had a decline in our level of non-accrual loans.

Looking at our loan loss reserves, again focusing on where we're at, at the bank, I talked about this where our loan loss reserve is 4.74% of our total loans outstanding. And again, if you compare that to our peers, they're anywhere from 2% to 2.5%. So again, we believe that we've been very aggressive in terms of posting loan loss reserves both on a specific reserve basis as well as on a general reserve basis. And one of the things that we've said to the world is that we believe relative to the loan loss reserve we have, relative to our legacy portfolio, we believe that we are adequately reserved on that portfolio. And going forward, our provisions are going to be much lower and are going to be more in line with the net loan growth that's happening at the bank.

Our credit quality outlook we believe is very stable now. The good news is that relative to our legacy loans, there are no new loans that are coming up that are being presented as problem loans that haven't been problem loans before. And as a result, we believe that's why our quarterly loan loss provision declined dramatically in the second quarter. And we expect the level that we were at the second quarter on a consolidated basis, which I said, we're at $25 million, it'll be about the number we'll be operating at going forward.

If you look at our provision history, that number's been kind of largely all over the place relative to on a quarterly basis. But we think now we're going to be at a much more kind of predictable number in that $20 million, $25 million range.

Our charge-offs, obviously because of the fact that we've taken a lot of reserves on our legacy portfolio, we'll expect to have large charge-offs related to that legacy portfolio. But again, we believe those loans are fully reserved for.

And the large portion of our problems has been in the commercial real estate portfolio. And so if you look at the charge-offs we've taken to date, 85% of that is on the commercial real estate side. Now going forward, we'll be doing transactions in the commercial real estate side, but it's going to be very different from what we were doing previously.

We're no longer going to be doing land loans. We're not going to be doing construction loans. We're not going to be doing repositioning of real estate loans. Instead we're going to be focused on the stabilized cash flow in commercial real estate loans, where obviously we think we're going to get lower yields than we have gotten previously before on the portfolio. But obviously, we expect to have far better credit outcomes than we've had before.

In terms of takeaways from the bank, I think the message that we're trying to get in terms of what's going to be happening at the bank, the first is we expect to have significant net loan growth at the bank. We have an asset origination platform. As I said, we have got 12 different specialty lines so when we're talking about the loan production that we're talking, which is $1.2 billion to $1.6 billion a year, a lot of people say, well, jeez, how can you do that? Nobody else can do loans. What is it that you have that other people don't?

And I think because of the fact that we have the specialty focus, we have a specialty focus in healthcare, the corporate asset finance, SBA, multifamily, technology and because of that, the fact that we've got a group of originators that are focused on their areas, we think that gives us a significant advantage. If you look at our origination group right now, we've probably got 100 people all together that are focused on originations and they're supplemented with approximately another 35 people that are focused on the underwriting analysis associated with it, so again, that group is separate from the origination group and it is meant to be there as a check.

We also think the other part of the story is our cost of funds are declining. Obviously, we don't expect them to go much lower than they are right now, but clearly that is at a nice low point. Our credit has stabilized and we believe that with the infrastructure that we have in the bank, that we

are ready to take that infrastructure, leverage that and continue to be able to improve our operating efficiency going forward.

Focusing on funding and liabilities, I want to spend some time talking about the balance sheet of CapitalSource, i.e. the parent. If you look at us on a total basis, we have been on a mission since the end of 2008 to reduce the debt that we have because of the fact that obviously the credit markets have changed and as a result, we needed to pay down our debt. Our debt has been reduced from $6.5 billion at December 31 of '08, to $3.8 billion as of today.

You will see a lot of that is – that's coming from a combination of our recourse debt that is paid down significantly, along with our non-recourse debt. And our non-recourse debt consists of the securitizations that we've done, along with non-recourse debt that we had on our healthcare sale-leaseback portfolio. This year one of the things we did was to sell our sale-leaseback portfolio, which actually created a significant amount of liquidity for us at the parent level and was instrumental in paying down our debt.

The other thing people always looked at before is what level of debt do we have maturing. We have no debt that's maturing this year. The only debt that we have maturing next year is our syndicated bank facility. That's a match-funded facility, so the proceeds that we're getting on the portfolio associated with that are being utilized to pay down the debt. And then we have our convertible debentures that are outstanding, where we have roughly $300 million of that maturing next year with the rest maturing in 2012.

Now for us, when you look at us from a liquidity perspective, at the end of the second quarter, the parent's liquidity was $376 million. So when you look at the level of debt that we have maturing in 2011, we fully expect to be in a position to have the cash that's there to be able to pay that debt without having to do anything outside of the ordinary course of business in order to pay that. And then we have the rest of our converts mature in 2012 and then after that, we've got our high-yield notes and then we've got our very long dated trust preferred securities which are at a very attractive rate of LIBOR plus 195.

On a consolidated credit basis, you'll see the second-quarter highlights were – was the theme that our credit has been stabilized. If you look at what I said – I talked about this earlier, our loan losses for the quarter were $25 million and that's a significant departure from where we were at the end of the first quarter where we had $219 million. And it's because of those reserves we posted in the first quarter, along with the stabilization in the second quarter, that we're comfortable saying we believe that our credit has stabilized and that we are fully reserved relative to the legacy loan loss portfolio.

If you look at our total loan loss reserve that's out there, roughly $150 million of that is specific loan loss reserves. The remaining $450 million is general reserves. So we think our general reserves are at a significant level that between the general and the specific we're confident we've got enough to cover the losses on our legacy portfolio.

In terms of our non-performing loans, as I mentioned, our total loans on non-accrual decreased slightly for the second quarter. We're not expecting any significant change in that number. Again, we think our non-accrual loan level has stabilized and as a result, that's why we will not be needing to post large provisions. And then our delinquencies have declined. So again, further supporting the fact that we believe our credit has stabilized.

In terms of charge-offs, we had a significant level of charge-offs in the second quarter and we expect that to continue happening. The large part of those charge-offs are on the commercial real estate side and we expect that's where our elevated charge-offs will continue and those charge-offs will be going against our existing reserves.

In terms of what's going to happen for the second half of 2010, we've actually had very good performance so far, in that we have had resolutions that happened in the second quarter and are also happening in the third quarter, where those resolutions are coming at numbers that are better than the level we have reserved to, which gives me comfort that we're marking these things appropriately and we're getting outcomes that are not having negative impacts on us.

We expect our loan loss provision to be at the – as I said, the more stable level relative to where we were in the second quarter. In commercial real estate, basically we only have three loans left that are not unimpaired. And by unimpaired, when a loan's impaired, that's when we actually look at it for taking a specific reserve. So relative to this, we believe we've only got three loans in the commercial real estate portfolio that we did not deem to be impaired; therefore, there are not specific reserves associated with those. But we do have general reserves associated with those. So again, we believe we've identified all of our problem loans and we're not expecting new ones to pop up.

And then we have a loan rating system and if you look at the loans and the ratings that we have on the loans in our system, we believe that's stable and again, there's been no – there's been improving trends associated with that.

In terms of looking at our year-to-date accomplishments, I think we're becoming a very simple story. One of the items we had was our sale-leaseback portfolio. As we moved into the bank model, it was clear that the sale-leaseback portfolio, which we had as part of our days as a REIT, really no longer was applicable to what we were trying to do. So we sold off our healthcare sale lease assets.

The other thing that we did was we deconsolidated – we're deconsolidating our 2006-A commercial real estate trust. That's a transaction where, quite frankly, we had recognized reserves that were far in excess of the economic interests that we had in that portfolio and, as a result, it was really kind of skewing our numbers and making it look worse than reality was. We did a transaction in the third quarter that will result in us deconsolidating that securitization. And again, you'll see that our story is a lot simpler.

I talked about the deleveraging. So far year-to-date, we've reduced our debt by $1.4 billion. The securitization's roughly $700 million of it. $460 million of that is from selling off the healthcare net lease segment and the rest of it is just natural reductions in our credit facility.

We've brought on three new lending platforms this year; the Corporate Asset Finance Group, which is an equipment finance group; the Professional Practice Group; and the Small Business Lending Group. And I think one of the things that these platforms bring to us that we – that is the fact that these platforms do not require acquisitions to be happening.

A lot of the transactions that we had done before was because there were corporate transactions happening. Somebody was buying a company or buying – making a corporate acquisition. These platforms are just normal run-of-the-mill capital needs that need to be provided for at companies.

So our business is not subject to the changes and the desire for acquisitions. It's more a function of just normal lending that is required to operate those businesses. And then we believe that our liquidity profile has improved significantly, primarily due to the net lease asset sales that we've had along with the payoffs that are paying down our syndicated bank facility.

In addition to that, we believe our credit performance has stabilized. Our total allowance has been raised to 7.5% of our commercial lending assets and, relative to the bank, we are growing CapitalSource Bank and we are embracing that as the model for new transactions.

So roughly we've had – if you look at what we've done so far this year, the bank has closed on just under $900 million in new commitments, of which $680 million of that has been funded. The yield that we've gotten on that has been in excess of 4%. We've got a solid net interest margin.

The cost of funds has dropped for us and for the first time ever, our bank size in terms of total assets is greater than the size of the parent and we're going to continue to see that where the parent is going to continue to decline and the bank assets are going to continue to grow.

In terms of our investment thesis, I think for us the big – the real message is we've really survived the credit crisis and we've been able to do all of this without any government assistance and we are moving forward.

So now when we say, all right, what do we look like, we're just -- we're moving to a pure bank model. It's a simple story, but we do think it's a viable and a stable long-term business model. We've got our national origination platform paired with our depository funding institution. We have a very well capitalized bank and our pre-provision earnings are expected to grow over the next few years.

Our credit has stabilized. Our loan loss provision is lower. The level of reserves is adequate to cover what we have in our legacy portfolio. And our charge-offs in 2011 should return to a more normalized level. We have got a return to profitability in terms of going forward. Our new funded loan originations, that we've talked about, is in this 1.3 billion to $1.5 billion level. We're definitely going to -- we're on track based on where we're at right now.

And then we believe that our liquidity profile has improved significantly. And the other benefit that we have out there is our deferred tax asset. We've got roughly a $500 million deferred tax asset outstanding. And once we return to profitability on a consistent basis, obviously that deferred tax asset that we have is going to be there in order to shelter our earnings going forward.

So with that, does anybody have any questions? Kurt?

QUESTION AND ANSWER SECTION

<Q – Kurt Hoffman>: With respect to the $3.5 billion of loans at the bank, what are your anticipated quarterly repayments in that portfolio so we can understand going toward net loan growth?

<A – James Pieczynski>: Right, I think going -- when you look at net loan growth going forward, as I said, we're probably going to be doing 300 million to $400 million in terms of new funding. When you sit there and say with run-offs, run-offs are probably going to be in roughly the $100 million zone. So I would expect our net loan growth to be roughly $100 million less than our existing originations.

And I think that loan growth is going to accelerate from where we were before because before we had our iStar loan, which is paying off and paying off significantly. It was 1.8 billion. It's now down to 30 million. And so as a result, we will now have significant loan growth going forward.

<Q – Kurt Hoffman>: Okay. And given the high capital ratios of the bank, how many new loans do you think you can make without increasing deposits?

<A – James Pieczynski>: The question is how much in new loans can we do without increasing deposits? We've got right now -- I look at it from a standpoint of the liquidity profile and where we're at relative to our capital ratios. We're currently at a 17.5% capital ratio. Based on where we're at today, we could originate $2 billion of new loans based on our existing capital basis.

Some of that cash would be utilized from liquidating our investment securities. Some of it would be with increasing new deposits, but it'll increase our spread. But roughly, with the capital base that we're at right now, we've got the ability to do like $2 billion of new loans today.

Any other questions?

<Q – Kurt Hoffman>: You've mentioned in the past potentially looking at becoming a bank holding company. What do you think some of the key advantages could be from that on a longer-term basis?

<A – James Pieczynski>: Right. The question is in terms of bank holding company status, we've said that's something that is a goal of ours. What are the advantages we get of ultimately getting bank holding company status? I think there's several advantages associated with it. The first is that with our bank right now, the bank that we have has an industrial loan charter, which means it's limited relative to its products. It can do savings account. It can give you CDs and it can do money markets. That's it.

By having the parent become a bank holding company status, it allows the bank to change its charter to a commercial banking charter, which therefore allows it to offer other depository type products, i.e. checking accounts.

Clearly, the cost of checking accounts is going to be lower than what we're paying for CDs right now. So it does give us the ability to expand the product offering. The other thing is by having a parent become a bank holding company, it puts us in the position to be able to participate in FDIC assisted transactions. We can't do that right now because of the fact that we're not a bank holding company. So I think those are really two of the primary benefits we get for doing bank holding company status.

And then the third thing is because of the fact that the bank is a stand-alone entity right now and the parent is a stand-alone entity right now, there's some duplication, duplicative functions that are

at the parent that are also at the bank. As we have the same – as we're regulated at the parent and regulated at the bank, it gives you the ability to morph some of those things together and eliminate some of the duplicative functions.

<Q – Kurt Hoffman>: And then with respect to right now tangible book consolidated is about 5.50, right, per share?

<A – James Pieczynski>: Yes.

<Q – Kurt Hoffman>: Per share consolidated?

<A – James Pieczynski>: Right.

<Q – Kurt Hoffman>: And so assuming you get the benefit of that deferred tax asset that would increase it to about $7?

<A – James Pieczynski>: That's good.

<Q – Kurt Hoffman>: And then the deconsolidation, the 2006-A trust, what does that add to book value?

<A – James Pieczynski>: The deconsolidation when it's all said and done – the question is what happens to book value as a result of a deconsolidation of the 2006-A trust. The end result of that is probably going to be anywhere from a 15 to a $25 million net gain that gets recorded as a result of that deconsolidation, which then translates into where we're at from our book value.

<Q>: [inaudible] (29:40:6)?

<A – James Pieczynski>: The question is relative to our legacy portfolio, what gives us the confidence that we're adequately reserved. And what gives me personally the most confidence is one of the things I did when I took over the role effective January 1 was literally to go through the portfolio and understand where we're at with respect to each and every asset and so we've done that.

In addition to that, we have had transactions now where we're seeing resolutions happen and those resolutions are happening at levels greater than we had originally reserved the loans to. So our outcome has been better. So from our perspective, we're getting anecdotal reasons as to why. And in terms of just looking at what's been happening in the portfolio right now, we're not seeing any significant level of deterioration. That doesn't mean that relative to a loan here or there you're going to have more reserves relative to that. Yeah, you probably will, but the other part of it is that we've got a significant level of general reserves that are booked against that legacy portfolio that are for problems that we just haven't identified yet.

And again, if you look at our total reserve, we're at $600 million, roughly 150 million of that or 25% is specific. The rest is general. So again, that gives me comfort that we're at a comfortable level.

I think my time is up, is that correct?

James J. Pieczynski, Co-Chief Executive Officer

Right. Okay. All right, thank you all very much. Appreciate it.