MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the CapitalSource Second Quarter 2010 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Dennis Oakes. Please go ahead, sir.

Dennis Oakes, Senior Vice President-Investor Relations

Thank you, Andrea. Good morning and thank you, everyone, for joining the CapitalSource earnings call for the second quarter of 2010. Joining me this morning are John Delaney, our Executive Chairman; Co-Chief Executive Officers, Jim Pieczynski and Steve Museles; and Don Cole, our Chief Financial Officer.

The call is being webcast live on our website, and a recording will be available beginning at approximately 12:00 noon, Eastern Time, today. Our earnings press release and website provide details on accessing the archived call. We have posted a presentation on our website this morning that provides additional detail on certain topics and which will be referred to during our prepared remarks.

Investors are urged to read the forward-looking statements language in our earnings release. But essentially, it says that statements made on this call, which are not historical facts, may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

All forward-looking statements, including statements regarding future financial operating results, involve risks, uncertainties and contingencies, many of which are beyond the control of CapitalSource and which may cause actual results to differ materially from anticipated results.

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

John will lead off the prepared portion of our call, after which we will take your questions. John?

John K. Delaney, Chairman and Co-Founder

Thank you, Dennis, and good morning, everyone. The overall performance of our business this quarter, particularly our return to profitability and the significant increase in new loans written at CapitalSource Bank, represent a clear turning point for the company, as we continue to successfully put the effects of the financial crisis behind us.

The progress we made this quarter is a reflection of the work we have done strategically and operationally over the last several years. Recognizing the negative effects of both the economic recession and the more severe balance sheet recession, we built substantial reserves over the past six quarters.

The dramatic decline in provisions this quarter to just 25 million is an indication that we have reached the point of relative stability in our portfolio and reflects that provisioning. It also provides further evidence for the view we articulated on our first quarter call that we have reached the point

where the level of reserves held against the legacy loan portfolio was sufficient to cover all cumulative losses.

In addition to meaningful net loan growth at CapitalSource Bank, credit stabilization and the return to profitability in the second quarter, we also completed the sale of our net leased assets, secure a highly qualified and experienced team to launch our small business lending effort, and reduced the parent company debt by nearly $1 billion.

Subsequent to the quarter-close, we took the steps necessary to deconsolidate our 2006-A commercial real estate securitization. Don, will provide more detail about the accounting implications of that transaction, but the move has three key benefits. First, by derecognizing the loans in which we have no economic interest, our financial statements will be simplified and more accurately reflect economic reality.

Second, the removal of approximately 930 million of loans with a carrying value of 801 million from the parent company balance sheet will accelerate the shift in the relative percentage of the company's total assets held at CapitalSource Bank, which we view as an important step on our path to bank holding company status and continued positioning of the business as a bank.

And third, the removal of nearly 900 million of debt from our balance sheet will contribute to the continued deleveraging of the parent, which is another goal of ours.

Before turning the call over to Jim, I want to touch briefly on the status of our plan for redeeming the convertible debentures, which are puttable roughly one year from now. After repurchase of 17 million at a modest discount to par in the second quarter, the outstanding balance on those converts is just under $300 million.

Given our current liquidity and cash flow expectations for the next 12 to 18 months, we were highly confident that we will have sufficient cash to redeem the converts, while maintaining the liquidity needed to run our business. Jim will provide some color on what a very strong quarter for all of our origination teams around the country. Jim?

James J. Pieczynski, Co-Chief Executive Officer

Thanks, John, and good morning to all of you who are listening on the call. Our origination level for this quarter was very strong, with new funded loans of $440 million, which is the highest level we've had in nine quarters and well above our targeted level of 250 million to 350 million for the quarter.

As a further testament to our diversified lending platform, the originations were spread among all of our business groups, thus, adding the benefit of diversification to the impressive volume.

As with the first quarter, the healthcare team underwrote the largest portion of new loans with asset-based cash flow and real estate originations that accounted for nearly 30% of the total funded loans in the quarter. We also funded loans in the security, technology, corporate asset finance, rediscount, commercial real estate and multi-family groups, which provided further diversification.

In addition to our internally generated loans, we also completed the acquisition of MainStreet Lender, which included the purchase of $100 million portfolio of small business loans, bringing our new loan level for the quarter to well over $0.5 billion.

In addition to this, we hired MainStreet's experienced small business lending team, and we've integrated them into our origination platform. The group also closed on its first loans during the quarter, and we are excited about the growth prospects in that lending space.

We believe that the value of our strong national direct origination franchise is quite evident at a time when many of our regional bank peers are reporting tepid loan growth, shrinking balance sheet, and rising but under-deployed deposits. It is also particularly gratifying to have the expertise now to make loans to the nation's small businesses, which are critical to job growth and the economic recovery.

Our recent designation as a National Preferred Lender by the U.S. Small Business Administration enhances our capacity to move quickly to make SBA loans to qualified borrowers and is recognition of the systems and personnel we have in place as well as the solid operating history of our new SBA team.

It is also important to point out that we are achieving meaningful growth in our quarterly loan production, despite smaller hold sizes than in prior years.

Excluding the small business loans, which we purchased in the MainStreet acquisition, the average loan size funded was $6 million, which is about a third smaller than loans made prior to the formation of CapitalSource Bank.

Roughly, 44% of the loans in the quarter were asset based; 42% were real estate, including multifamily, healthcare and commercial real estate; and 14% were cash flow loans concentrated in technology and healthcare.

We are clearly seeing incremental signs of slowly improving economic activity and just as important increasing conviction among investors and management team, which gives us the confidence necessary to boost our projected range for quarterly loan originations to 300 million to $400 million for the balance of 2010.

Our focus on our specialized niche areas of lending with a national focus continues to pay dividend. The competition will inevitably return. We feel we will have significant continuing opportunities in our specialized lending spaces.

With that, I will turn the call over to Steve who will provide detail about other key components of the performance of CapitalSource Bank in the second quarter and then touch on operating expenses.

Steve?

Steven A. Museles, Co-Chief Executive Officer

Thanks, Jim, and good morning, everyone. In addition to the significant net loan growth, which Jim spoke about in detail, the second quarter was solidly profitable for CapitalSource Bank. Our net finance margin remained a healthy 4.44% and loan spread was 7.03%, although net interest income in both of these measures were down slightly in the quarter due to an increase in loans on non-accrual and lower loan discount accretion.Our cost of funds declined again this quarter, as the average rates for new and renewed CDs fell to 1.16%. And our average weighted interest rate on deposits declined to 1.27%. Despite these drops, deposits held steady at 4.6 billion.

With the continuing low interest rate environment projected for the foreseeable future, we are now expecting our cost of funds to remain in a 125 to 140 basis point range through the end of the year, which is about 30 to 40 basis points lower than our expectations six months ago.

Overall credit performance at the bank generally improved in the quarter. Most noteworthy was a significant decline in quarterly loan loss provisions, from 88 million in the first quarter to 5 million this quarter.

Certain of the loans we purchased in the MainStreet transaction were delinquent and purchased at a discount. They appear on our numbers for the first time this quarter. Excluding those loans, short-term delinquencies remained less than 5 million and 90-plus day delinquencies were down slightly, amounting to under 2% of core loans.

For the balance of 2010, the bank will continue to focus on loan growth and improved financial and credit performance. Although we have made gains on all of these fronts, we did see a 66 million increase in non-accruals this quarter.

The bank's non-accruals are concentrated in the legacy commercial real estate loans, and there are only a handful of large CRE loans in the bank that aren't already impaired in our non-accrual status as of June 30. In fact, there are only 10 CRE loans larger than 15 million, totaling 548 million, which are current and accruing. Four of those are legacy loans totaling 312 million.

New non-accruals in the quarter relate primarily to one large loan, which was current in quarter-end. Over 80% of all the loans we have on non-accrual at the bank are current, which is indicative of our approach of recognizing problem loans early and taking appropriate credit related actions.

Operating expenses at the bank were up about 5 million in the quarter as a result of higher loan sourcing fee paid to the parent. For those of you who aren't aware, the bank pays the parent a loan referral fee for each new commitment for the bank. And those fees are immediately expensed in the month the loan is closed. The higher level of referrals, therefore, the higher the charge the bank will report.

Absent these referral fees, operating expenses at the bank were flat for the quarter. Because such inter-company items are eliminated in consolidation, the more meaningful expense number to focus on is the consolidated operating expense, which was down significantly again this quarter to 54 million.

That's nearly 10 million less than the prior quarter and more than 20 million less than the fourth quarter of 2009, primarily due to decreases in severance, compensation, benefits and workout-related expenses. We're extremely pleased to show such continued solid progress in our efforts to reduce third-party and other credit-related costs. Our ability to do so also reflects the improving credit performance of our legacy loan portfolio.

Looking at the quarter in total, net income at the bank was 38 million compared to a loss of 40 million in the first quarter, a solidly profitable performance as I mentioned at the outset. Don is up next. He will provide greater detail about companywide credit and general balance sheet strengthening in the quarter, including substantial debt reduction and an improved liquidity profile.

Don?

Donald F. Cole, Chief Financial & Administrative Officer

Thank you, Steve, and good morning. Our solid profitability at the bank and consolidated net income of $0.06 per share were the headlines for the second quarter. But there were several other important achievements, as our balance sheet continued to strengthen and delever and credit improved meaningfully.

Liquidity strengthened further in the quarter, principally as a result of the completion of the remaining net lease asset sales to Omega, which added 95 million of cash and contributed to the improvement of available parent liquidity to $376 million at quarter's end.

Our cash position is net of the repurchase during the quarter of approximately 17 million of the 4% convertible debentures, which reduced the amount outstanding and puttable next July to approximately $294 million. As John mentioned, we believe we will have sufficient cash to redeem the converts.

Our bank credit facilities and term securitizations continued to pay down rapidly. The combined decline in the second quarter was over $500 million, and the sale of our net leased assets resulted in an additional debt reduction of approximately $465 million.

Slide 16 and 17 of the investor presentation show the updated balances in our securitizations and credit facilities as well as their net change from the prior quarter. As you can see, several of these transactions are approaching the point where the debt will be paid off in full.

As we enter 2011 we will begin to free up considerable collateral, which will ultimately be converted to cash at the parent. The syndicated bank facility will also be repaid in full during 2011. These are all positive developments, as we continue to simplify and strengthen the parent company balance sheet.

With the deconsolidation of the 2006-A securitization, which I will touch on in more detail in a moment, total parent company debt will decline from nearly $10 billion at the end of 2008 to just over $2.5 billion today.

Total loan repayments in the second quarter were $435 million, including 290 million of legacy loans repaid at the parent and 65 million at CapitalSource Bank. There were also 80 million of non-legacy loans repaid at the bank. The greatest repayments in the quarter were experienced in the cash flow portfolio.

Before turning to credit, with the sales I mentioned earlier to Omega now complete, we've presented the financial condition and results of operations of assets within our Healthcare Net Lease segment as discontinued operations for all periods presented in our current quarter financials. Our second quarter net income reflects a pre-tax gain of $22 million on the sale of the remaining 103 long-term care facilities.

Now, turning to consolidated credit performance for the second quarter, we saw a dramatic reduction on our quarterly loan loss provision, which declined from 219 million last quarter to just 25 million this quarter. This, of course, is the primary reason for the improvement in earnings this quarter.

As John mentioned, this level of quarterly provisions is consistent with our previously articulated view that the level of reserves against our legacy loan portfolio is adequate to cover the charge-offs embedded in that portfolio. Troubled asset sales we have completed in recent weeks provide further support for that view.

In the second quarter, we resolved 10 loans with preexisting charge-offs. As of 12/31/09, those loans had a net book balance of $72 million. Payments received on those loans were $84.5 million for a net 2010 recovery of $12.5 million.

There are several factors, which caused the GAAP accounting view of provisioning for the second quarter to align with our economic analysis that reserving for the legacy loan portfolio is largely complete. Most of the charge-offs in the second quarter were for loans for which a specific reserve existed at the end of the first quarter or from loan categories, such as land, where our general reserve methodology anticipated such charge-offs.

Also, our internal risk ratings on our non-impaired loans improved during the quarter, and the balance of loans on our watch list decreased. Finally, the mix of our portfolio continues to shift

towards asset types that have performed better over the full history of the company, including healthcare and other asset-based loans.

Regarding the first factor I mentioned related to charge-off of previously held specific reserves, of the 133-million charge-off during the quarter, 89.5 million was for 34 loans against which we had 132 million of specific reserves. Another substantial charge-off was one large land loan. While we did not have a specific reserve against that loan as of March 31, land loans are a part of our portfolio that has suffered substantial losses and, therefore, one against which we have significant general reserves as a percent of the outstanding balance. In fact, the actual charge-off recorded on this loan was nearly 10 percentage points less than the general allowance factor against the land loan category as of March 31.

Pro forma for the 2006-A deconsolidation transaction, our remaining commercial real estate book as of June 30 of approximately $790 million would be approximately 12% of our total loan portfolio and would include only 47 legacy loans with a balance of $536 million.

With few remaining large commercial real estate loans on our books and our view that we're fully reserved for all of our legacy loans, we believe the future credit performance and related earnings impact of the commercial real estate portfolio is largely accounted for.

We have updated the cumulative loss slide that we have been using for over a year in our investor presentation at slide 20. As you can see, reserves to-date are just above the high end of our projected range and little change from the prior quarter.

On a separate slide, 22, we have also provided a specific look at the credit characteristics of 2006-A securitization and have summarized the charge-offs and reserves in the securitization as a new line in the cumulative loss line. Going forward, we will no longer need to reserve against loans in that portfolio, which accounted for 36 million of charge-offs and 12 million of provisions in the second quarter.I want to take a moment to explain the accounting treatment of the 2006-A deconsolidation. With the transaction closed in July, the impact will not be seen until our third quarter financials and some accounting work remains to be completed before we can report the actual bottom line result. But I can provide a roadmap for understanding the key components of the transaction.

First, as of the transaction date we will no longer show the results of the loans and debt associated with the securitization, reflecting approximately $930 million in gross loans and 135 million in reserves we held as of June 30. Nor will we reflect the 891 million in underlying term debt associated with the securitization.

There are three items that will determine the net impact of this deconsolidation. The $7 million in consideration we received, our GAAP equity securitization, which net of all reserves and charge-offs stood at close to zero as of June 30, and the 124 million face value of 2006-A bonds we continue to own.

We ultimately expect to report a gain on this deconsolidation, which will be comprised of $7 million we receive for the sale our interest plus the fair market value of the bonds we continue to hold. We expect that fair value to be in the 15 million to $20 million range.

We may ultimately collect significantly more than these marks as these assets will be recorded as fair value, calculated assuming a very high rate of return. This transaction will also improve many of our credit metrics which were disproportionately impacted by the asset pool of the 2006-A securitization that was highly concentrated in commercial real estate.

Slide 22 shows 2006-A non-accruals of 28% of the total securitization balance of 930 million as of June 30. Delinquencies were 25% and impairments were 42%, almost entirely in the 425 million of commercial real estate in the securitization.

Before turning the call back to John for his closing remarks, I want to touch briefly on the valuation allowance on the deferred tax asset which increased to $511 million as of June 30. The DTA allowance will exist until there is sufficient positive evidence to support its reduction or reversal. As we have stated previously such evidence would include a period of positive pre-tax income for several quarters. So our profitability this quarter is a first step in that process.

Income tax in the quarter was a benefit of $4.2 million and primarily the result of certain GAAP versus tax adjustments that allowed us to release a small portion of our DTA allowance during the quarter. Our third quarter results will reflect a decline of approximately $70 million in the DTA valuation allowance as a result of the deconsolidation of the 2006-A securitization though it should have no impact on our income statement.

John will have some brief concluding remarks and then we will be ready for questions.

John K. Delaney, Chairman and Co-Founder

Thanks, Don. I want to close by highlighting our current strategy which will take us through the balance of this year and into 2011. First and foremost, we're executing the remaining stages of our successful transition to a pure bank model. Second, we will continue to vigorously manage the credit performance of our now shrinking legacy loan portfolio at both the parent company and the bank in order to maximize returns and minimize losses.

Now we've indicated that we believe we are fully reserved which means we anticipate minimal future P&L impacts from reserving for the legacy portfolio we can still add value by continuing the kind of hands on management we have always exercised with our borrowers and working out troubled loans with the goal of achieving recoveries above our marks, a result which we have accomplished more frequently in recent weeks.

Third, we have returned the company to profitability this quarter but must continue to work hard to sustain that profitability and grow it. Continuing to originate new loans at CapitalSource Bank, that are carefully underwritten and highly profitable, will allow us to achieve that goal.

Fourth, we want to continue to pay down debt, simplify our capital structure and bolster our already strong liquidity at the parent. We made substantial progress in that regard this quarter. Turning the parent legacy portfolio into cash over the next 24 to 36 months, which can ultimately be deployed to invest in the business or return to share holders in some fashion is a very high priority of ours. As part of this strategy, we will begin to take the preliminary steps needed to redeem the 2011 converts, utilizing internally generated cash.

Finally, we are intently focused on taking all the preparatory steps necessary to apply for bank holding company status, so we can ultimately convert CapitalSource Bank to a commercial charter. While the revised charter would have no short-term impact on the company, it is important for long-term positioning of the business.

To that end, we are putting in place the policies and procedures at the parent company necessary to be consistent with the regulatory scheme to which we would be subject as a bank holding company.

Another criteria having relatively more assets at the bank then the parent is improving each quarter as bank grows and the parent shrinks. The deconsolidation of 2006-A will have a big impact on

these relative numbers at the end of the third quarter. Two days ago we celebrated the second anniversary of CapitalSource bank. I want to particularly thank Bank CEO Tad Lowrey, his senior team and all employees at the company for their very hard work in these initial two years.

Very few if any, non-bank lenders were able to successfully transition to a bank model without major interruptions in their business or government assistance.

Our team did just that and we are certainly very proud of their efforts. We do believe that CapitalSource is uniquely positioned as a national lending franchise with a strong California base regional depository to grow and prosper. Our model has few competitors and we believe we will be able to grow assets over the next two to three years when many other regional and local banks will face an asset gap because of their ability to make new loans, will be constrained in various ways including geography and a generally heavy reliance on residential and commercial real estate lending which is unlikely to return to pre-crisis levels.

The second quarter of 2010 was a good moment for the company. Much work still lies ahead, but we are all highly confident of our ability to meaningfully grow assets and profitability at CapitalSource Bank in both the short and the long term. While we simultaneously continue the process of monetizing the parent assets and freeing up it's very significant trapped equity. Operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Bob Napoli of Piper Jaffray. Please go ahead.

<Q – Robert Napoli>: Thank you. Good morning. Question, I guess how confident are you guys that you will be able to maintain profitability in future quarters?

<A – John Delaney>: This is John. I will start off. We are confident. I mean, the main driver in our profitability has been the provisioning, or the main negative driver if you will in our historic lack of profitability has been provisioning. We said you some time that we believe on an economic basis that we're fully reserved. And this quarter we saw the GAAP reality effectively line up with that and based on what we are seeing in the business, we don't see any reason that that should change.

<Q – Robert Napoli>: Second question, given that, how long – is there a specific role – I mean I don't think there is a specific role in the deferred tax asset if you have increasing profitability. Is it mid-2011 so to say you report profits for the next four quarters and at that point, what is your feel for when that deferred tax asset would be able to be recognized?

<A – John Delaney>: Bob, you are right. I think there is not specific guidance on that. And so I think it's difficult to say with precision but I think if we keep this level of profitability up for, you mentioned middle of 2011, that will be four, five quarters in a row. I think we will start having serious conversations about it. It may be that it happens in sort of an entity by entity basis because the bank I would say has a much better cumulative operating performance history than the parent company. But I think you're right to start thinking about it as a mid- to end of 2011 type of discussion.

<Q – Robert Napoli>: And then last question, now that you are starting to emerge from the challenges of the past and still certainly not all the way there, but do you have – what is your vision of the business model, the return on equity, return on capital kind of growth rate of the bank? And I know it's early a little bit. But I'm sure you have those thoughts and I'm sure you have in-depth business plans around that model.

<A – John Delaney>: Jim, why don't you take that?**<A – James Pieczynski>:** Yeah. I think obviously going forward – relative to the bank all of our lending going forward is going to be at the bank. And in terms of ROE levels, that will ultimately going to be looking at on the bank on kind of a go-forward basis once everything is stabilized it's going to be kind of in that 12 to 15% range.

<A – John Delaney>: And that's with very high capital levels.

<Q – Robert Napoli>: And you would hope to get to that level on a sustained basis next year?

<A>: Yes. I think that's exactly right. I mean, from the standpoint relative to the originations we have and being able to redeploy the liquidity at the bank I would expect to be there sometime next year.

<Q – Robert Napoli>: Okay. Thank you.

Operator: Thank you. Our next question comes from John Hecht of JMP Securities. Please go ahead.

<Q – John Hecht>: Good morning guys. Thanks for taking my questions. First one is just related to the deconsolidation of 2006-A, it sounds like you expect if I heard you right it's a $7 million book value recovery plus at 15 to $20 million fair value mark. Is there any specific provision recovery that would also accompany this, or is it really just a fair value mark situation?

<A – John Delaney>: John, I mean, I'd say it's really the latter of that and just to explain, I mean, this transaction leads to that LCD consolidating which means all of its assets and liabilities in one sense effectively just disappear the moment we close it on July 9. So, it's not that we would wash the provision back or the reserves back to our provision line or charge-off all the loans or release the debt. It's just kind of move the net equity off the books and that's how you calculate your gain or loss. So you won't see anything going through the provision line as a return. It really will just be this one gain number that will be comprised of those items you mentioned.

<Q – John Hecht>: Okay. Thanks. And I'm wondering if you can discuss the margins and the types of terms you are seeing in the loans funded at the bank?

<A – Donald Cole>: Yeah, I mean relative to – our spread this quarter on average was just slightly over 7% over 30-day LIBOR right now. So our yields have been generally with your looking at yields that are done in the bank, they are generally going to be in the 7 to 8.5% zone. The maturities that we're doing obviously are varying, but most of our loans are being structured as 3 to 5-year loans, and on average the expected life is probably going to be around four years.

<Q – John Hecht>: And if I remember correctly about earlier this year you were extending the duration of the deposits at the bank just to prepare for rising rate environment. And things have shifted in the yield curve. What's your position there now and what are you doing just on an interest rate management perspective?

<A – Donald Cole>: Sure. On deposits, we had tried to extend out a little bit and I think you saw the weighted average remaining maturity, if you will, the CDs going out a little bit. I think we eased off on that a bit. But as the rate curve is flattened we are trying to kind of push a little bit some of the longer terms CDs. So, I think where it is now is probably a good place in the sense it will stay in for the short term.

<Q – John Hecht>: Okay. And final question is, the REO expense this quarter, if you can provide any guidance there, is that a level we should see consistent for the next couple quarters as you've kind of guided to the charge-offs for the remaining part of the year?

<A – Donald Cole>: I think, this is sort of a high end of level. I mean the REO portfolio in a book itself is not that large, and a little bit lumpy. I think – so this charge-off was really kind of a few situations. One of the areas we talked about monetary discount where we had a bunch of foreclosures that we really I think kind of taken to the bone. And I will say the REO book is somewhere in the $140 million range as of quarter end. We've already actually sold one of those assets for a little bit of a recovery. So I wouldn't expect to have that level run rate. I think it's going to come back down to a much, much smaller number.

<Q – John Hecht>: Great. Appreciate the detail. Thanks.

Operator: Our next question comes from Sameer Gokhale of Keefe, Bruyette & Woods. Please go ahead.

<Q – Sameer Gokhale>: Hi, thank you. Just a couple of questions. Don, you talked about the credit quality of the bank and I missed it I think. I was just wondering the sequential increase in dollar charge-offs in the bank, were those related to some – I know in Q1 you had those specific reserves for commercial real estate loans. I mean, were these related to those or were these – there was a sequential increase due to some other assets that charged off. And would you expect charge-off at the bank then trend lower or be flat from the level in Q2.

<A – Donald Cole>: I would say it's a little of both. The ones we mentioned where we took specifics there were charge-offs this period. But there was the one large land loan I mentioned was

partly in the bank and partly in the day securitization. So a chunk of it is charge-offs. Not quite half where related to the one large land loan. And what I would say is expected run rate, I think we expect that – this not to be the run rate. I think we expect it to come back down to sort of in the range closer to 1Q rather than this high amount because that one large loan is highly concentrated.

<A>: Right. And we talked in the past about how we have roughly half a dozen situations that are relatively large. And that we had built up substantially the specifically general reserves against them, this was one of those situations.

<Q – Sameer Gokhale>: Okay. Thank you. That's very helpful. And then just the other question on the DTA. I was just trying to figure out the debits and credits here because it looked like the valuation allowance and total increased compared to last quarter the net valuation allowance is roughly the same and there didn't seem to be any P&L impact so – this quarter at least as far as I can tell. So can you just talk a little bit how that valuation allowance increased? Was it just a balance sheet reclass entry or something like that?

<A – John Delaney>: The allowance itself increased more around one of the entities – the parent side entities still lost the money. And so that caused the DTA allowance to go up more than whatever would cause the decrease on the bank side.

<Q – Sameer Gokhale>: Okay. But it flow through the income statement looks like this quarter because you had that net benefit and so I was just trying to figure out at least based on the numbers I can see didn't flow – that expense didn't flow through the income tax line item this quarter to add to the devaluation allowance.

<A>: We can give you more detail for that offline, we're not going to get into the detail. There is a little bit of power that DTA allowance is offset by some of the tax liabilities on liability side and there is also impact between sort OCI tax adjustments in the DTA allowance. So, it gets pretty precise accounting rules. But I would say at the end of day staying close to that net zero until we have the full release is where we expect to be, but there always be a little bit of this noise.

<Q – Sameer Gokhale>: Okay. That's helpful. I guess, it seemed a little confusing when I first saw it, but I will follow up offline. And then just a last question on the reserve coverage ratio if you look at the reserve to non-accruals, where do you see that at this point kind of stabilizing? How much lower do you think that can go?

<A – John Delaney>: Well, I think we – that's a relevant metric, but it's not the metric that drives our reserving policy. So, I don't think we would typically forecast that. I think the more relevant kind of commentary, if you will, on the reserving is the fact that we do believe we are fully reserved. And the non-accrual – the percentage of non-accrual loans, the percentage of impaired loans will move around depending upon stages of resolutions, et cetera. And we don't really look at that coverage ratio as the relevant metric for determining level of reserves, et cetera.

<Q – Sameer Gokhale>: Okay.

<A>: I agree to that and just add we've always been fairly sort of proactive in charging off portions of loans, fairly rapidly. So in one sense, you look at the reserves, if you added up the charge-off on loans that we've already taken on those loans, it becomes a much higher percentage. So after taking the two together that coverage ratio can be a little sort of misleading.

<A – John Delaney>: We also have very high – if your question was related also to the coverage ratio on non-accrual loans, we've been very aggressive about making loans or putting loans in the non-accrual status. Over 80% of the loans that are on non-accrual are current pay loans.

<Q – Sameer Gokhale>: Yeah. I was just trying to get a sense for it, now we've figured out the cumm loss estimates and you're fully provisioned for your legacy portfolio, the question is going forward where do we see that, because from the outside looking in some, we are trying to triangulate where your reverse ratio will end up because that is how in conjunction with forecast and charge-off of guide where provisioning should go. So I mean I'm just trying to get a sense for that, but your commentary is helpful.

<A – John Delaney>: Yeah. We'll think about what the way you're looking at it there and try to be a little more specific on some of that.

<Q – Sameer Gokhale>: Terrific. Thank you, John.

Operator: Thank you. Our next question is from Don Fandetti of Citigroup. Please go ahead.**<Q – Donald Fandetti>:** Hi. Good morning. Question on your cash flow loans, it looks like the repayments have been pretty nice source of liquidity there. Do you expect that to continue based on what you are seeing and also we're seeing some sort of credit issues pop up as more time goes by with the economy remaining sluggish. Could you comment a little bit on your outlook for credit and your cash flow line.

<A – Donald Cole>: Yeah, I would say relative to when you're looking at the cash flow space, first of all when you're talking about the liquidity associated with loans, obviously our goal, and we stated it for awhile, is to have the legacy portfolio at the parent continue to decline and we certainly expect that to be a source of liquidity in the future. As it relates to the level of loans that we're doing, obviously we are doing all of our loans at the bank and that's where we will continue to do it. So from our perspective, the parent is going to be generating additional funds on a regular basis from the recovery of the legacy portfolio.

<A – John Delaney>: We also think from a credit perspective, the legacy – the cash flow loans, we have a relatively large portfolio of legacy cash flow loans, the good news there is that at this point it's very seasoned. And certain aspects of that portfolio experienced a lot of stress early on in the cycle. Loans tied to the media industry, loans tied to the retail industry, etcetera, experienced more relative stress than others. And we think those loans are really fully worked through the system at this point. And the likelihood of further credit charges against those loans in the future is very, very small if any.

<Q – Donald Fandetti>: Okay.

<A – John Delaney>: And then the rest of the portfolio again is relatively seasoned and a lot of them are very highly rated with high coverage statistics, etcetera. Obviously, if there is some kind of double dip, it's vulnerability in that portfolio based on the kind of loans they are.

<Q – Donald Fandetti>: Right.

<A – John Delaney>: But at this point the good thing about that portfolio is that it's very seasoned. And as Jim spoke about new originations of the cash flow business are much more focused on the specialty areas. The legacy portfolio is a little more of a generalist business. Which on the margin didn't perform well as specialty businesses, but still we have the benefit of lots and lots of seasoning. So I think for us to really have a different view about the credit performance and the legacy cash flow business it will have to be tied to some kind of new dramatic change in the economic landscape. At least that's our view how that's been performing.

<Q – Donald Fandetti>: So, John, obviously you and the team have done a good job of getting through the situation here. What is your sort of – are you expecting – are you in this for the long haul and what are you sort of focusing on right now at the moment?

<A – John Delaney>: Well, what – if the question is about what I'm personally focusing on right now, I mean think there is a couple of – having a reserve built done and being at a point where we are fully reserved on an economic and then on a GAAP basis is obviously important point for the company.

And as I've had a view for a while that everything kind of changes when that happens in some ways. And I think what we are seeing is a rapid kind of liquidation of the parent, slightly ahead of schedule, obviously that's aided by the 06-A deconsolidation, but in general we are seeing lots of pay downs at the parent. So very focused on continuing to harvest cash and pay down debt of parent, so that the parent basically becomes overtime a pool of cash or a pool of unlevered loans. And we think you can head in that direction and then we'll have a decision to make whether the bank needs the cash because we think the bank has a very high return on equity model and it's a great home for the cash or if it doesn't return to our share holders.

From the bank perspective I think things are proceeding beautifully there. I mean, the banks ability to raise deposits is very good. The cost of the deposits is very low. The capital levels are very high and you can see from this quarter's origination performance it was – it's even more impressive I think than the absolute numbers because as Jim indicated there's a lot of breadth in terms where those originations came from. It's a very granular portfolio and I think the asset origination platform is really hitting on all cylinders and performing in a very high standard.

So I think in many ways the people's view of the company I think should start changing quite dramatically because we have successfully made it to the other side. We were fully provisioned. The book is fully marked. We are making new loans. We have high capital and lots of liquidity.

We have some capital harvesting still to do because we do have a lot of capital trapped in a very inefficient way at the parent. So the sooner we get that capital out of the parent and either into the bank or back into the hands of the shareholders is important. So in general, I'm focused on those kind of things.

<Q – Donald Fandetti>: Okay. And in terms of your role and you're committed to the long haul in terms of CapitalSource?

<A – John Delaney>: Yes.

<Q – Donald Fandetti>: Okay. Thank you.

Operator: Thank you. Our next question is from Mike Taiano of Sandler O'Neill. Please go ahead.

<Q – Michael Taiano>: Hey, good morning. Just I had a clarification question on the 2006-A deconsolidation. So is the 15 to 20 million, is that the value of that 124 million debt piece that you own? So in other words, the mark is – I don't know what like 80% or something like that?

<A – John Delaney>: Yes.

<Q – Michael Taiano>: Okay. Okay. And then the reserve would basically that you had in there would effectively go back up to the parent or I guess you would recognize the specific reserve and the general reserve would go back to the parent?

<A – James Pieczynski>: No, I mean as I tried to explain, and this is, I realize it's kind of complicated. Basically the whole – because we are not selling assets, the whole SBA is just sort of going away with the sales or deconsolidate, and those reserves will just go away from the balance sheet. So it's not that they will come to the parent. I think you're going to expect as a pro forma starting here the 135 or so of reserve that are shown in the presentation would just be deducted from our consolidated balance sheet.

<Q – Michael Taiano>: Okay. Got it. Okay, and then just in terms of how to think about like what affected the lower provision this quarter. Is it more function of what you saw in the early stage delinquencies? I think they were down something 60% linked quarter. Or is it also more of a function of what you're seeing on the recovery side at this stage?

<A – John Delaney>: I would say it's not the former. It's somewhat the latter. I think the key points to make are that much of the charge-offs in the period were either for loans for which we had prior specific reserves or loan categories for which we had very large general reserve allocations.

And so over time what we've seen is continuing shift in the mix of the remaining portfolio away from those categories. I mentioned the one large land loan where the 46 million of charge-offs were for that one large land loan. So, it's really the charge-offs are in the areas where we expected them to be. And then the remaining credit profile got better in terms of the shift and mix and the shift in our own internal risk rates.

<Q – Michael Taiano>: Got it. Okay. And then in terms of the loans originated at the bank, was there any sort of concentration geography-wise. Was it more in California, given where that's – where the bank is based.

And I guess what do you think is really driving the stronger loan origination? Is it just pure demand is stronger? Or are you just more confident in your outlook, so you're more willing to lend. Can you give us some context as to what do you think is the main driver there.

<A – John Delaney>: Yes. Relative to concentration relative to geography, during the quarter relative to the multifamily lending that we did, the large portion of that is concentrated in Southern California and so in terms – so that there is a concentration there. Relative to the other areas of real estate, both healthcare and commercial, it really wasn't a concentration in any one particular state. I mean they were spread out and there wasn't a significant concentration. And in terms of the originations going forward and why are we confident in it. From my perspective, the way I look at it, is as I said we're now telling the world that we will be at 300 to $400 million on a quarterly basis. And that's based on me literally meeting with all of the Group Heads and going through their origination targets for the rest of the year based on the existing pipeline that as they know, some of which is already – we've already committed to doing and gone through the approval levels. And others where we have term sheets issued that were highly confident. So I think because of the fact that we've got many diversified groups that are out there and we've also added the new SBA team. The originations are coming from all, across all the platforms, so when you take that 300 to 400 million and spread that among our various platforms it's a reasonable target for each of the groups.

<Q – Michael Taiano>: All right. Okay. And then just finally maybe for John. I mean you talked about harvesting capital at the parent and this is probably some time to go before you get where you want to be. But as it stands today, I mean it seems like there is plenty of capital in the bank and it's got significant cash and liquidity. I mean is there a preference looking at it today to return capital to shareholders?**<Q – Henry Coffey>:** Good morning, everyone. Two questions, first of course in 2011 if I got my dates right, you in essence reconsolidate your tax return. Does that then leave you in a situation where the profitability of the bank might accelerate your ability to start reversing the DTA?

<A – Steven Museles>: So, I think, yeah, to clarify your question, I think what we've said is that starting in 2011 we can reconsolidate from a federal tax filing perspective.

<Q – Henry Coffey>: Right, right exactly.

<A – Steven Museles>: That's right. And so, in a sense, yes, I mean from a GAAP perspective today we're looking at all these entities somewhat independently of one another. So once we sort of

determine that we will reconsolidate, and we're able to use the sort of long term forecasted net income of the bank to offset the parents NOLs that will help us sort of bring some things back and faster.

Ultimately, the reason why we sort of got into this allowance position was that the trailing 12 quarter cumulative profit of these entities was negative and the bank is still in that position. But the bank will obviously sooner than the rest get out of that spot. So it is a good question, it is true that at some point the bank's profitability and the bank's own forecast will help us release some of the other others faster, if not all a third portion of it. But again, I think that's still a, as we mentioned a 2011 to end of 2011 sort of action.

<Q – Henry Coffey>: So even, so the September 2011 is an early trigger date for something like this?

<A – Steven Museles>: I think the 2011 tax year is the reconsolidation year. I think the key steps will be cumulative profitability at the bank which could actually happen this year and then establishing the history of profitability over the whole organization to make the analysis. So I mean, September I think I'm not sure the exact driver of that date, but ultimately I think it's a mid to end of 2011 discussion will start to have about is this the time to start reserving – I mean sorry, reversing all portion of that.

<Q – Henry Coffey>: Thank you. And then John, this may be hearsay, but except for the fact that it would allow you to probably more easily participate in failed bank deals, you've got tons of liquidity. I guess I have my own opinions about regulators. But what are the other economic advantages of becoming a bank holding company? What – except for that one item of failed bank deals but beyond that is there any sort of economic value to being a bank holding company that you can't realize without that status?

<A – John Delaney>: So as I said in my comments, there's no short-term impact to the company associated with becoming a bank holding company, turning CapitalSource to a commercial bank. It doesn't give us more capital, it doesn't give us more liquidity. It doesn't lower our cost of funds. It doesn't give us more asset opportunities. So all the key drivers of the profitability of the company, it doesn't help with any of those, which is kind of I think what you're getting at Henry. However, life is long and there are lots of changes occurring in the financial services industry as you know. And having a charter that provides us maximum flexibility we think is a strategic priority for the company. And that flexibility can present itself in the positive and the negative. And what I mean by that is, obviously on the positive we have a commercial bank and a charter bank holding company. We could avail ourselves failed bank opportunities and other transactions that may only be reserved for companies that have holding company status. Both things we know about and things we can imagine.

Under the category of flexibility almost around the negative is the ILC charter that we have is a charter that I would describe as historically a very successful charter but one that for a variety of reasons is viewed negatively by a lot of regulators and stakeholders and people on Capitol Hill who talk about these things oftentimes without all the facts. But – and so taking that risk off the table is a worthy goal as well.

<Q – Henry Coffey>: Thank you.

Operator: Our last question today comes from Moshe Orenbuch of Credit Suisse. Please go ahead.

<Q – Moshe Orenbuch>: I'm here. Sorry about that. Basically I wanted to kind of drill down a little more to a couple of questions that were asked about this quarter being the turning point from the reserve release and kind of to some degree from a regulatory perspective. Could you just talk a

little bit more because I think some of the things that you mentioned in terms of having the marks and really were present in previous quarters, it seems like there should have been – is there something in terms of your relationship with the regulators that really did kind of achieve some turning point?

And also can you tack on to that a discussion of the bank has got two characteristics that don't – you don't often see within banks and one is a relative – a very high NPA ratio and actually loan – new loan growth. Usually you don't see the two of those together. So you can talk about the regulatory relationship and how that's evolving.

<A – Steven Museles>: I'll start with the regulatory relationship. None of our reserving this quarter or anything is impacted by our relationship with the regulators. Nothing has changed with them. We continue to have very positive, productive and from our perspective respectful and deferential relationship with our current regulators. So they weren't really involved in any – there were no discussions with them around this particular quarter. So I'll let Don address the rest of your questions, Moshe.

<A – Donald Cole>: Yeah, and I would say in terms of, I mean, Steve basically answered it. There was no real change. None of the change or none of the reserving process [inaudible] was impacted by the regulators or any relationship there. I mean, the regulators obviously review the bank's loan loss reserve methodology. I think they've been very comfortable with it and the bank followed the same process.

And really you mentioned some of the things that drove this for present and prior periods. I'm not exactly sure they were. I think again, the things we've mentioned about moving out some of these loan categories that we've had lots of problems with. I mean, the charge-offs and one land loan that was a situation that our general reserving methodology both at the bank and consolidated had allocated a significant portion of that and resolving that situation leads to a charge-off which should shrink our total overall allowance.

And then much of these other factors in terms of credit quality, mix shift and some of the loans that paid off and actually some of these recoveries we've received are new to the second quarter. I mean, until the second quarter we haven't seen a lot of good asset recoveries or certainly any pickups on these troubled loans that we've resolved. So those things that happened in the second quarter really weren't that existent prior to 3/31/10.

<Q – Moshe Orenbuch>: Okay. Thanks. And in terms of the fact that the bank has kind of double-digit level of NPAs. Does that in and of itself – I understand the fact that you're focused on kind of the recovery value. Do the regulators raise any red flag with respect to them?

<A – Steven Museles>: But obviously, Moshe, you know that bank metrics they do focus on NPAs, they focus on obviously, regulatory classifications. So it's certainly a number they focus on. It's a number that we focused on and it's not necessarily I would say a positive number. But I think on the flip side of that, I think they understand that it comes from largely the legacy portfolio bought from the parent.

I think they understand exactly sort of what management's doing to deal with those assets, aren't comfortable with management's approach to resolving the credit issues and they realize we're trying to push that number down as rapidly as possible and get these things to a positive resolution. So, yes, it's obviously a concerning number. It's a concerning number for us, it's a concerning number for them, but I think they understand how we're managing it and how we're managing through the rest of the legacy portfolio.

<A – John Delaney>: And I would just add to that a little bit more texture. I think one of the things that we were relatively early with respect to was identifying problem loans, putting them on non-

accrual, and taking good size provisions against them. I think relative to a lot of other institutions that they look at, I think they didn't see as much kind of proactive behavior in others as they did in us.

And I would say on more than one occasion they made that point to us and said we understand what you're doing and we think it's the right thing that you're doing. In other words, putting assets on non-accruals, because we do have a high percentage of our non-accrual assets are currently over 80%. And a lot of the assets that are impaired have very low risk of loss based on underlying collateral coverage and things like that. And so I would say that the regulators – again, we certainly don't speak to them, but what we can say is, as Steve said earlier, the relationship is very good.

They understood the actions we took with respect to putting assets on non-accrual status and putting up good sized reserves against them. I think, in general, they would have liked to have seen that being done by more institutions they regulate. And I think they understand that we have a very high capital level, so we have the flexibility to do that. Clearly they like the ratios to go down as would we, and we expect them to. But it doesn't strike out as problematic as relates to our relationship. And certainly our ability to lend and make a lot of loans, which we are, is kind of first evidence of the fact that they don't have any problems with it, because if they had problems, they would tell us not to lend.

<Q – Moshe Orenbuch>: Got it. Thanks.

Dennis Oakes, Senior Vice President-Investor Relations

Thank you everybody for listening. That will be our call for today. And just to reminder that the transcript of the call will be up later and an archive of the call will be available on our website later today. Thank.

Operator: Thank you. This concludes today's conference. Thank you for attending. You may now disconnect.