FLAGSTAR BANCORP INC
Form 10-Q
November 08, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number: 001-16577

(Exact name of registrant as specified in its charter)

Michigan	**38-3150651**
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)
5151 Corporate Drive, Troy, Michigan	**48098-2639**
(Address of principal executive offices)	(Zip code)

(248) 312-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days. Yes þ No o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ.

As of November 2, 2007, 60,270,624 shares of the registrant s common stock, $0.01 par value, were issued and outstanding.

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FORWARD LOOKING STATEMENTS

This report contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of Flagstar Bancorp, Inc. (Flagstar or the Company) and these statements are subject to risk and uncertainty. Forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, include those using words or phrases such as believes, expects, anticipates, plans, trend, objective, continue, remain, pattern or similar expressions or future or conditiona as will, would, should, could, might, can, may or similar expressions.

There are a number of important factors that could cause future results to differ materially from historical performance and these forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed under the heading Risk Factors in Part I, Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2006, including: (1) competitive pressures among depository institutions increase significantly; (2) changes in the interest rate environment reduce interest margins; (3) the Company s estimates of prepayment speeds, loan origination and sale volumes, charge-offs and loan loss provisions differ materially from actual results; (4) general economic conditions, either national or in the states in which the Company does business, are less favorable than expected; (5) political developments, wars or other hostilities may disrupt or increase volatility in securities markets or other economic conditions; (6) legislative or regulatory changes or actions adversely affect the businesses in which the Company is engaged; (7) changes and trends in the securities markets result in an adverse effect to the Company; (8) a delayed or incomplete resolution of regulatory issues; (9) the impact of reputational risk created by the developments discussed above on such matters as business generation and retention, funding and liquidity; and (10) the outcome of regulatory and legal investigations and proceedings.

The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

The unaudited condensed consolidated financial statements of the Company are as follows:

Consolidated Statements of Financial Condition — September 30, 2007 (unaudited) and December 31, 2006.

Unaudited Consolidated Statements of Operations — For the three and nine months ended September 30, 2007 and 2006.

Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss) — For the nine months ended September 30, 2007 (unaudited) and for the year ended December 31, 2006.

Unaudited Consolidated Statements of Cash Flows — For the nine months ended September 30, 2007 and 2006 (restated).

Unaudited Notes to Consolidated Financial Statements.

Statement regarding Computation of Net Earnings Per Share

Section 302 Certification of Chief Executive Officer

Section 302 Certification of Chief Financial Officer

Section 906 Certification, as Furnished by the Chief Executive Officer

Section 906 Certification, as Furnished by the Chief Financial Officer

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Flagstar Bancorp, Inc.
Consolidated Statements of Financial Condition
(In thousands, except for share data)

	At September 30, 2007 (Unaudited)	At December 31, 2006
Assets		
Cash and cash items	$ 123,373	$ 136,675
Interest-bearing deposits	102,356	140,561
Cash and cash equivalents	225,729	277,236
Securities classified as trading	22,401	
Securities classified as available for sale	1,216,186	617,450
Mortgage-backed securities held to maturity (fair value $1.3 billion and $1.6 billion at September 30, 2007 and December 31, 2006, respectively)	1,343,778	1,565,420
Other investments	24,780	24,035
Loans available for sale	5,604,041	3,188,795
Loans held for investment	7,034,732	8,939,685
Less: allowance for loan losses	(77,800)	(45,779)
Loans held for investment, net	6,956,932	8,893,906
Total interest-earning assets	15,270,474	14,430,167
Accrued interest receivable	63,820	52,758
Repossessed assets, net	84,248	80,995
Federal Home Loan Bank stock	331,094	277,570
Premises and equipment, net	229,354	219,243
Mortgage servicing rights, net	340,814	173,288
Other assets	121,822	126,509
Total assets	$ 16,564,999	$ 15,497,205
Liabilities and Stockholders Equity Liabilities		
Deposits	$ 8,485,556	$ 7,623,488
Federal Home Loan Bank advances	6,392,000	5,407,000
Security repurchase agreements	468,668	990,806
Long term debt	248,685	207,472
Total interest-bearing liabilities	15,594,909	14,228,766
Accrued interest payable	46,183	46,302
Federal income taxes payable	17,721	29,674
Secondary market reserve	27,500	24,200
Payable for securities purchased		249,694
Other liabilities	149,780	106,335
Total liabilities	15,836,093	14,684,971

Commitments and Contingencies				
Stockholders Equity				
Common stock $0.01 par value, 150,000,000 shares authorized; 63,656,979 and 63,604,590 shares issued and outstanding at September 30, 2007, and December 31, 2006, respectively		637		636
Additional paid in capital		64,075		63,223
Accumulated other comprehensive (loss) income		(8,366)		5,182
Retained earnings		714,239		743,193
Treasury stock, at cost, 3,386,355 shares at September 30, 2007, and none at December 31, 2006		(41,679)		
Total stockholders equity		728,906		812,234
Total liabilities and stockholders equity	$	16,564,999	$	15,497,205

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Operations
(In thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
	(Unaudited)			
Interest Income				
Loans	$ 201,464	$ 184,328	$ 578,673	$ 526,222
Mortgage-backed securities	15,485	19,878	43,869	58,177
Securities available for sale	15,212		42,334	
Interest-bearing deposits	3,647		9,823	
Other	1,343	1,351	5,486	5,104
Total interest income	237,151	205,557	680,185	589,503
Interest Expense				
Deposits	91,117	87,054	262,181	244,326
FHLB advances	70,534	48,677	203,268	131,147
Security repurchase agreements	17,982	13,161	48,416	39,707
Other	3,582	3,037	10,495	11,282
Total interest expense	183,215	151,929	524,360	426,462
Net interest income	53,936	53,628	155,825	163,041
Provision for loan losses	30,195	7,291	49,941	17,213
Net interest income after provision for loan losses	23,741	46,337	105,884	145,828
Non-Interest Income				
Loan fees and charges	(218)	2,146	1,257	4,996
Deposit fees and charges	5,808	5,080	16,496	15,584
Loan administration	4,333	7,766	10,097	12,430
Net gain (loss) on loan sales	(17,457)	(8,197)	35,841	18,538
Net gain on sales of mortgage servicing rights	456	45,202	6,181	88,719
Net loss on securities available for sale	(2,944)	(2,144)	(2,215)	(5,701)
Unrealized gain on trading securities	1,914		1,914	
Other fees and charges	9,376	4,485	29,039	23,966
Total non-interest income	1,268	54,338	98,610	158,532
Non-Interest Expense				
Compensation and benefits	40,037	37,518	118,680	108,735
Occupancy and equipment	17,599	17,726	51,380	51,335
Communication	1,114	1,108	4,518	3,295
Other taxes	(470)	(21)	(1,053)	(1,652)

General and administrative	14,980	12,522	43,367	37,564
Total non-interest expense	73,260	68,853	216,892	199,277
(Loss) earnings before federal income taxes	(48,251)	31,822	(12,398)	105,083
(Benefit) provision for federal income taxes	(16,196)	11,070	(3,233)	36,780
Net Loss (Earnings)	$ (32,055)	$ 20,752	$ (9,165)	$ 68,303
(Loss) earnings per share				
Basic	$ (0.53)	$ 0.33	$ (0.15)	$ 1.08
Diluted	$ (0.53)	$ 0.32	$ (0.15)	$ 1.06

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss)
(In thousands, except per share data)

	Common Stock	Additional Paid in Capital	Other Comprehensive Income (Loss)	Accumulated Retained Earnings	Treasury Stock	Total Stockholders Equity
Balance at January 1, 2006	$ 632	$ 57,304	$ 7,834	$ 706,113	$	$ 771,883
Net earnings				75,202		75,202
Reclassification of gain on swap extinguishment			(1,167)			(1,167)
Change in net unrealized loss on swaps used in cash flow hedges			(1,874)			(1,874)
Change in net unrealized gain on securities available for sale			389			389
Total comprehensive income						72,550
Stock options exercised	4	2,201				2,205
Stock-based compensation		2,718				2,718
Tax benefit from stock-based compensation		1,000				1,000
Dividends paid ($0.60 per share)				(38,122)		(38,122)
Balance at December 31, 2006	636	63,223	5,182	743,193		812,234
(Unaudited)						
Net loss				(9,165)		(9,165)
Reclassification of gain on swap extinguishment			(91)			(91)
Change in net unrealized loss on swaps used in cash flow hedges			(2,684)			(2,684)
Change in net unrealized loss on securities available for sale			(10,773)			(10,773)
Total comprehensive loss						(22,713)
Adjustment to initially apply FIN 48				(1,428)		(1,428)
Stock options exercised	1	69				70

Stock-based compensation		808				808
Tax effect from stock-based compensation		(25)				(25)
Purchase of treasury stock					(41,705)	(41,705)
Issuance of treasury stock					26	26
Dividends paid ($0.30 per share)				(18,361)		(18,361)
Balance at September 30, 2007	$ 637	$ 64,075	$ (8,366)	$ 714,239	$ (41,679)	$ 728,906

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows
(In thousands)

	For the Nine Months Ended September 30,	
	2007	**2006**
	(Unaudited)	
		(as restated)
Operating Activities		
Net (loss) earnings	$ (9,165)	$ 68,303
Adjustments to net (loss) earnings to net cash used in operating activities		
Provision for loan losses	49,941	17,213
Depreciation and amortization	71,692	80,129
(Decrease) increase in valuation allowance in mortgage servicing rights	(358)	48
Stock-based compensation expense	1,119	1,797
Net gain on the sale of assets	(3,041)	(2,010)
Net gain on loan sales	(35,841)	(18,538)
Net loss on securities classified as available for sale	2,215	5,701
Unrealized gain on trading securities	(1,914)	
Net gain on sales of mortgage servicing rights	(6,181)	(88,719)
Proceeds from sales and securitizations of loans available for sale	16,031,878	10,647,153
Origination and repurchase of mortgage loans available for sale, net of principal repayments	(19,018,391)	(11,835,950)
Increase in accrued interest receivable	(11,062)	(4,737)
Decrease (increase) in other assets	387	(39,682)
(Decrease) increase in accrued interest payable	(119)	7,041
Net tax effect of (benefit for) stock grants issued	25	(905)
Decrease in federal income taxes payable	(21,229)	(22,667)
Decrease in payable for securities purchased	(249,694)	
Increase in other liabilities	8,318	4,774
Net cash used in operating activities	(3,191,420)	(1,181,049)
Investing Activities		
Net change in other investments	(745)	(3,117)
Repayment of mortgage-backed securities held to maturity	249,475	300,543
Proceeds from sale of investment securities available for sale	254,937	
Purchase of investment securities available for sale, net of principal repayments	(132,755)	
Proceeds from sales of portfolio loans	693,283	1,256,646
Origination of portfolio loans, net of principal repayments	708,063	(614,908)
(Purchase) redemption of Federal Home Loan Bank stock	(53,524)	17,611
Investment in unconsolidated subsidiaries	1,238	
Proceeds from the disposition of repossessed assets	70,318	42,068
Acquisitions of premises and equipment, net of proceeds	(25,891)	(32,032)

Proceeds from the sale of mortgage servicing rights	33,915	371,703
Net cash provided by investing activities	1,798,314	1,338,514
Financing Activities		
Net increase in deposit accounts	862,068	68,152
Net decrease in security repurchase agreements	(522,138)	(325,602)
Net increase in Federal Home Loan Bank advances	985,000	292,308
Payment on other long term debt	(25)	(25)
Issuance of junior subordinated debt	40,000	
Net receipt (disbursement) of payments of loans serviced for others	17,069	(39,630)
Net receipt of escrow payments	19,931	18,064
Proceeds from the exercise of stock options	(241)	2,557
Net tax effect of (benefit for) stock grants issued	(25)	905
Dividends paid to stockholders	(18,361)	(28,583)
Purchase of treasury stock	(41,705)	
Issuance of treasury stock	26	
Net cash provided by (used in) financing activities	1,341,599	(11,854)
Net (decrease) increase in cash and cash equivalents	(51,507)	145,611
Beginning cash and cash equivalents	277,236	201,163
Ending cash and cash equivalents	$ 225,729	$ 346,774

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows Continued
(In thousands)

	For the Nine Months Ended September 30,			
	2007		**2006**	
	(Unaudited)		(as restated)	
Supplemental Disclosure of Cash Flow Information				
Loans held for investment transferred to repossessed assets	$	88,576	$	77,322
Total interest payments made on deposits and other borrowing	$	524,479	$	419,421
Federal income taxes paid	$		$	61,253
Mortgage loans available for sale transferred to securities available for sale	$	406,094	$	
Mortgage loans available for sale transferred to held for investment	$	210,639	$	247,771
Mortgage loans held for investment transferred to available for sale	$	693,283	$	1,256,646
Recharacterization of loans held for investment to mortgage-backed securities held to maturity	$	345,794	$	440,707
Mortgage servicing rights resulting from sale or securitization of loans	$	247,570	$	175,141
Retention of residual interests in securitization transactions	$	20,487	$	

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Notes to Consolidated Financial Statements
(Unaudited)

Note 1. Nature of Business

Flagstar Bancorp, Inc. (Flagstar or the Company), is the holding company for Flagstar Bank, FSB (the Bank), a federally chartered stock savings bank founded in 1987. With $16.6 billion in assets at September 30, 2007, Flagstar is the largest financial institution headquartered in Michigan.

The Company s principal business is obtaining funds in the form of deposits and wholesale borrowings and investing those funds in single-family mortgages and other types of loans. Its primary lending activity is the acquisition or origination of single-family mortgage loans. The Company also originates consumer loans, commercial real estate loans, and non-real estate commercial loans and services a significant volume of residential mortgage loans for others.

The Company sells or securitizes most of the mortgage loans that it originates and generally retains the right to service the mortgage loans that it sells. These mortgage-servicing rights (MSRs) are occasionally sold by the Company in transactions separate from the sale of the underlying mortgages. The Company may also invest in a significant amount of its loan production in order to enhance the Company s leverage ability and to receive the related interest spread between earning assets and paying liabilities.

The Bank is a member of the Federal Home Loan Bank System (FHLB) and is subject to regulation, examination and supervision by the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). The Bank s deposits are insured by the FDIC through the Deposit Insurance Fund (DIF).

Note 2. Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of the Company and its consolidated subsidiaries. All significant intercompany balances and transactions have been eliminated. In accordance with current accounting principles, the Company s trust subsidiaries are not consolidated. In addition, certain prior period amounts have been reclassified to conform to the current period presentation.

The unaudited consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles for interim information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America (U.S. GAAP) for complete financial statements. The accompanying interim consolidated financial statements are unaudited; however, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the three and nine month periods ended September 30, 2007, are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. For further information, you should refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. The Form 10-K can be found on the Company s Investor Relations web page, at **www.flagstar.com**, and on the website of the Securities and Exchange Commission, at **www.sec.gov**.

Note 3. Recent Accounting Developments

Establishing Standards on Measuring Fair Value

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements.* SFAS 157 defines the term fair value for U.S. GAAP purposes to include the use of an exit price, establishes a framework for measuring fair value by reference to an exit price, and expands disclosures about fair value measurements. It also clarifies that the exit price is the price in an orderly transaction between market participants to sell an asset or transfer a liability at a measurement date. SFAS 157 emphasizes that fair value is a market-based measurement and not an entity-specific measurement. It also establishes a hierarchy used in such measurement and expands the required disclosures of assets and liabilities measured at fair value. Management will be required to adopt SFAS 157 beginning in 2008. Management is currently evaluating the potential impact on the Company s financial condition, results of operation and liquidity.

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Fair Value Option

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities.* SFAS 159 allows entities to elect to measure those financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The election may be applied instrument by instrument, is irrevocable once made and must be applied to the entire instrument and not to specified risks, specific cash flows or other limited aspects of that instrument. An entity is restricted in choosing the dates to elect the fair value option for an eligible item. SFAS 159 applies to the Company effective January 1, 2008. Management is currently evaluating the potential impact of SFAS 159 on the Company s financial condition, results of operation and liquidity.

Note 4. Investment Securities

As of September 30, 2007 and December 31, 2006, investment securities were comprised of the following (in thousands):

	September 30, 2007	December 31, 2006
Securities trading	$ 22,401	$
Securities available for sale		
AAA-rated non-agency securities	$ 851,715	$ 497,089
AAA-rated agency securities	323,439	77,910
Non-investment grade residual securities	41,032	42,451
Total mortgage-backed securities available for sale	$ 1,216,186	$ 617,450
Mortgage-backed securities held to maturity		
AAA-rated non-agency securities	$	$ 332,362
AAA-rated agency securities	1,343,778	1,233,058
Total mortgage-backed securities held to maturity	$ 1,343,778	$ 1,565,420
Other investments		
Mutual funds	$ 24,071	$ 23,320
U.S. Treasury bonds	709	715
Total other investments	$ 24,780	$ 24,035

At September 30, 2007, the Company had $22.4 million in securities classified as trading. These securities are non-investment grade residual assets from a private securitization that was closed in March 2007 with a secondary closing in June 2007. The securities are recorded at fair value with any unrealized gains and losses reported in the consolidated statement of operations. Prior to this transaction, the Company had no securities classified as trading.

At September 30, 2007, the Company had $1.2 billion in securities classified as available for sale, which were comprised of AAA-rated agency securities, AAA-rated non-agency securities and non-investment grade residual securities arising from its private securitizations. Securities available for sale are carried at fair value, with unrealized gains and losses reported as a component of other comprehensive income to the extent they are temporary in nature. If losses are, at any time, deemed to have arisen from other-than-temporary impairments (OTTI), then they are reported as an expense for that period. At September 30, 2007, $48.3 million of the securities classified as available for sale were pledged as collateral for security repurchase agreements.

During the quarter ended March 31, 2007, the Company received written guidance from the OTS on regulatory capital treatment being used by the Bank for securities retained from a guaranteed mortgage securitization of fixed second mortgage loans completed in April 2006. The securities had initially been recorded as held to maturity because the underlying bonds were AAA-rated and insured by a private insurance company and, therefore, the Bank expected that the securities would receive 20% risk-weighted capital treatment rather than 50% or 100% risk-weighted treatment. At the time, the Company had both the ability and intent to hold the securities to maturity. In its guidance, the OTS advised the Company that the recharacterization of the underlying loans in the guaranteed mortgage securitization did not decrease the risk associated with carrying fixed second mortgage loans because the capital rules did not recognize private insurance companies as eligible guarantors. Because of this information received from the OTS, the Company s capital treatment of the underlying securities changed significantly. As a result, the Company no longer intends to hold the securities to maturity and during the quarter ended March 31, 2007, reclassified $321.1 million in securities associated with the guaranteed mortgage securitization of fixed second mortgage loans completed in April 2006 to available for sale. Upon reclassification of the securities to available for sale, the Company recorded a $1.3 million loss, before taxes, to other comprehensive income. Management does not believe that this capital treatment could have been reasonably anticipated and the reclassification to available for sale should not impact the held to maturity status of the Company s other held to maturity securities.

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At September 30, 2007, the Company had $1.3 billion in AAA-rated mortgage-backed securities classified as held to maturity. Of such securities, $425.9 million were pledged as collateral for security repurchase agreements at September 30, 2007.

The Company has other investments because of interim investment strategies in trust subsidiaries, collateral requirements required in swap and deposit transactions, and Community Reinvestment Act investment requirements. U.S. Treasury bonds in the amount of $508,000 and $517,000 are pledged as collateral in association with the issuance of certain trust preferred securities at September 30, 2007 and December 31, 2006, respectively.

Note 5. Loans Held for Investment

Loans held for investment are summarized as follows (in thousands):

	September 30, 2007	December 31, 2006
Mortgage loans	$ 4,938,083	$ 6,211,765
Second mortgage loans	58,224	715,154
Commercial real estate loans	1,463,222	1,301,819
Construction loans	88,018	64,528
Warehouse lending	175,496	291,656
Consumer loans	291,889	340,157
Commercial loans	19,800	14,606
Total	7,034,732	8,939,685
Less: allowance for loan losses	(77,800)	(45,779)
Total	$ 6,956,932	$ 8,893,906

Activity in the allowance for loan losses for the three and nine months ended September 30, is as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Balance, beginning of period	$53,400	$39,606	$ 45,779	$ 39,140
Provision charged to operations	30,196	7,290	49,941	17,213
Charge-offs	(6,895)	(4,716)	(20,746)	(15,668)
Recoveries	1,099	564	2,826	2,059
Balance, end of period	$77,800	$42,744	$ 77,800	$ 42,744

A loan is impaired when it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement.

Impaired loans are summarized as follows (in thousands):

	September 30, 2007	December 31, 2006
Impaired loans with no allowance for loan losses allocated	$ 23,583	$ 15,228
Impaired loans with allowance for loan losses allocated	94,427	10,934

Total impaired loans	$	118,010	$	26,162
Amount of the allowance allocated to impaired loans	$	18,861	$	1,119
Average investment in impaired loans (nine months ended September 30, 2007 and twelve months ended December 31, 2006, respectively)	$	54,640	$	28,469

Those impaired loans not requiring an allowance represent loans for which the estimated fair value of the collateral exceeded the recorded investments in such loans. At September 30, 2007, approximately 70% of the total impaired loans were evaluated based on fair value of related collateral, and the remaining 30% were based on discounted cash flows.

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Note 6. Private Securitization Activity

During 2007, the Company sold $719.1 million in closed-ended, fixed and adjustable rate mortgage loans (the Second Mortgage Securitization) and recorded $26.8 million in residual interests and servicing assets as a result of the non-agency securitization. The residual interests are categorized as securities classified as trading and are therefore recorded at fair value. Any gains or losses realized on the sale of such securities and any subsequent changes in unrealized gains and losses are reported in the consolidated statement of operations.

Certain cash flows received from securitization trusts outstanding, including the trust arising from the Second Mortgage Securitization, were as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Proceeds from new securitizations	$	$	$719,097	$
Proceeds from collections reinvested in securitizations	93,869	11,957	184,817	56,206
Servicing fees received	1,928	1,035	5,050	2,734
Loan repurchases for representations and warranties			(642)	(727)

Credit Risk on Securitization

With respect to the issuance of private-label securitizations, the Company has limited credit exposure in that it retains non-investment grade residuals. The Company does not have credit exposure associated with non-performing loans in securitizations beyond its investment in retained interests in non-investment grade residuals. The value of the Company s retained interests includes credit loss assumptions on the underlying collateral pool to estimate this risk. The following table summarizes the collateral balance associated with our servicing portfolio of sold loans and the balance of non-investment grade residuals retained at September 30, 2007 (in thousands):

	Total Loans Serviced	Balance of Retained Assets with Credit Exposure Residuals
Private label securitizations	$ 1,467,933	$ 63,433
Government sponsored entities	25,196,260	
Other investors	859	
Total	$ 26,665,052	$ 63,433

Note 7. Stock-Based Compensation

On January 1, 2006, the Company adopted SFAS 123R, Share-Based Payment, using the modified prospective method. SFAS 123R requires all share-based payments to employees, including grants of employee stock options and stock appreciation rights, to be recognized as an expense in the consolidated statement of operations based on their fair values. The total amount of compensation is determined based on the fair value of the options when granted and is expensed over the required service period, which is normally the vesting period of the options. SFAS 123R applies to awards granted or modified on or after January 1, 2006, and to any unvested awards that were outstanding at December 31, 2005. In accordance with SFAS 123R, for the period beginning January 1, 2006, only the excess tax benefits from the exercise of stock options are presented as financing cash flows. For the nine months ended September 30, 2007 and 2006 the excess tax effect totaled $0.9 million and $0, respectively. During the nine months ended September 30, 2007, there were no options granted.

Cash-Settled Stock Appreciation Rights

The Company used the following weighted average assumptions in applying the Black-Scholes model to determine the fair value of cash-settled stock appreciation rights issued and outstanding during the three months ended September 30, 2007: dividend yield of 3.40%; expected volatility of 33.81%; a risk-free rate range of 4.50% to 4.59%; and an expected life range of 3.65 to 4.60 years. The cash-settled stock appreciation rights generally vest over a four year period at the rate of 25% on each anniversary date of the grant.

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The following table presents the status and changes in cash-settled stock appreciation rights for the period presented:

	Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Stock Appreciation Rights Awarded:			
Non-vested balance at December 31, 2006	328,873	$ 16.28	$ 2.99
Granted	590,692	$ 14.34	$ 1.43
Vested	(82,197)	$ 16.28	$ 2.99
Forfeited	(5,525)	$ 14.48	$ 1.39
Non-vested balance at September 30, 2007	831,843	$ 14.91	$ 1.89

For the three months ended September 30, 2007 and 2006, the Company recorded stock-based compensation expense of $0.4 million ($0.3 million net of tax) and $0.4 million ($0.3 million net of tax), respectively, which had no impact on earnings per share. For the nine months ended September 30, 2007 and 2006, the Company recorded stock-based compensation expense of $1.1 million ($0.7 million net of tax) and $1.8 million ($1.2 million net of tax), respectively, or $0.01 per share, diluted, for each such period.

Restricted Stock Units

The Company issues restricted stock units to officers, directors and key employees in connection with year-end compensation. Restricted stock units generally vest over a period of two years as outlined in the applicable restricted stock unit agreements, and are delivered shortly after the grant date. The Company incurred expenses of approximately $0.3 million and $0.2 million with respect to restricted stock units for the quarter ended September 30, 2007 and 2006, respectively. For the nine months ended September 30, 2007 and 2006, the Company incurred expenses of approximately $0.9 million and $0.6 million, respectively. As of September 30, 2007, restricted stock units granted but not yet vested had a market value of $1.5 million.

Note 8. Stockholders Equity

On January 31, 2007, the Company announced that the Board of Directors had adopted a Stock Repurchase Program under which the Company was authorized to repurchase up to $40.0 million worth of shares of outstanding common stock. On February 27, 2007, the Company announced that the Board of Directors had increased the authorized repurchase amount to $50.0 million. On April 26, 2007, the Board increased the authorized repurchase amount to $75.0 million. This program expires on January 31, 2008. At September 30, 2007, $41.7 million has been used to repurchase 3.4 million shares under the plan.

Note 9. Segment Information

The Company s operations are broken down into two business segments: banking and home lending. Each business operates under the same banking charter, but is reported on a segmented basis for this report. Each of the business lines is complementary to each other. The banking operation includes the gathering of deposits and investing those deposits in duration-matched assets primarily originated by the home lending and commercial lending operations. The banking group holds these loans in the investment portfolio in order to earn income based on the difference or spread between the interest earned on loans and the interest paid for deposits and other borrowed funds. The home lending operation involves the origination, packaging, and sale of loans in order to receive transaction income. The home lending operation also services mortgage loans for others and sells MSRs into the secondary market. Funding for the home lending operation is provided by deposits and borrowings garnered by the banking group. All of the non-bank consolidated subsidiaries are included in the banking segment. No such subsidiary is material to the Company s overall operations.

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Following is a presentation of financial information by segment for the periods indicated (in thousands):

	For the Three Months Ended September 30, 2007			
	Bank Operations	Home Lending Operations	Elimination	Combined
2007				
Net interest income	$ 23,806	$ 30,130	$	$ 53,936
Gain on sale revenue		(17,001)		(17,001)
Other income	10,056	8,213		18,269
Total net interest income and non-interest income	33,862	21,342		55,204
(Loss) earnings before federal income taxes	(24,469)	(23,782)		(48,251)
Depreciation and amortization	2,482	21,815		24,297
Capital expenditures	4,437	6,633		11,070
Identifiable assets	15,879,011	6,175,988	(5,490,000)	16,564,999
Inter-segment income (expense)	41,175	(41,175)		

	For the Nine Months Ended September 30, 2007			
	Bank Operations	Home Lending Operations	Elimination	Combined
2007				
Net interest income	$ 87,819	$ 68,006	$	$ 155,825
Gain on sale revenue		42,022		42,022
Other income	39,261	17,327		56,588
Total net interest income and non-interest income	127,080	127,355		254,435
(Loss) earnings before federal income taxes	(8,877)	(3,521)		(12,398)
Depreciation and amortization	7,466	64,226		71,692
Capital expenditures	20,267	5,616		25,883
Identifiable assets	15,879,011	6,175,988	(5,490,000)	16,564,999
Inter-segment income (expense)	105,233	(105,233)		

	For the Three Months Ended September 30, 2006			
	Bank Operations	Home Lending Operations	Elimination	Combined
2006				
Net interest income	$ 42,111	$ 11,517	$	$ 53,628
Gain on sale revenue		37,005		37,005
Other income	4,159	13,174		17,333
Total net interest income and non-interest income	46,270	61,696		107,966
Earnings before federal income taxes	14,378	17,444		31,822
Depreciation and amortization	2,492	15,173		17,665

Capital expenditures	7,407	1,641		9,048
Identifiable assets	14,416,661	3,753,364	(3,050,000)	15,120,025
Inter-segment income (expense)	22,875	(22,875)		

	For the Nine Months Ended September 30, 2006			
	Bank Operations	Home Lending Operations	Elimination	Combined
2006				
Net interest income	$ 124,798	$ 38,243	$	$ 163,041
Gain on sale revenue		107,257		107,257
Other income	18,410	32,865		51,275
Total net interest income and non-interest income	143,208	178,365		321,573
Earnings before federal income taxes	47,589	57,494		105,083
Depreciation and amortization	7,209	72,920		80,129
Capital expenditures	29,504	2,382		31,886
Identifiable assets	14,416,661	3,753,364	(3,050,000)	15,120,025
Inter-segment income (expense)	57,300	(57,300)		

Note 10. Accounting for Uncertainty in Income Taxes

In September 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109,* (FIN 48), to clarify the accounting treatment for uncertain income tax positions when applying FASB Statement 109, *Accounting for Income Taxes.* This interpretation prescribes a financial statement recognition threshold and measurement attribute for any tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Effective January 1, 2007, the Company adopted FIN 48. As a result, the Company recorded the estimated value of its uncertain tax positions by increasing its tax liability by $1.4 million and recording a corresponding reduction to retained earnings. The liability for uncertain tax positions is carried in other liabilities in the consolidated statement of financial position as of September 30, 2007. The Company does not expect any reasonably possible material changes to the estimated amount in its liability associated with its uncertain tax position through December 31, 2007.

The Company recognizes accrued interest and penalties related to uncertain tax positions in the federal income tax provision and other tax expense. At January 1, 2007, the Company had accrued approximately $0.7 million for the payment of tax related interest. As of September 30, 2007, there have been no material changes to the disclosures noted above.

The Company s income tax returns are subject to review and examination by federal, state, and local government authorities. On an ongoing basis, numerous federal, state, and local examinations are in progress and cover multiple tax years. As of September 30, 2007, the federal taxing authority had completed its examination of the Company through the taxable year ended December 31, 2003. The years open to examination by state and local government authorities vary by jurisdiction.

Note 11. Restatement of Previously Issued Consolidated Financial Statements

Subsequent to filing the Company s Form 10-Q for the quarterly period ended March 31, 2007, the Company determined that its previously issued Consolidated Statements of Cash Flows contained errors in the classification of certain loan and securitization activities. As a result, the Company has restated the accompanying unaudited Consolidated Statement of Cash Flows for the nine months ended September 30, 2006.

The restatement resulted from the misclassification of cash flows from the sale of certain mortgage loans originally held for investment, which had been inappropriately classified as operating activities, and cash flows from certain mortgage loans originated as available for sale, which had been inappropriately classified as investing activities. In accordance with SFAS 102, "*Statement of Cash Flows-Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, cash flows from the sale of mortgage loans originally held for investment should have been classified as investing activities rather than operating activities, and cash flows from mortgage loans originated to be sold should have been classified as operating activities rather than as investing activities.

The restatement also resulted from the treatment of capitalized mortgage servicing rights and residual interests retained from the sale or securitization of loans. Previously, the Company had treated the retention of such interests as cash activities. In accordance with SFAS 140, "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* the mortgage servicing rights and residual interests do not exist until they are separated from the associated loans when the loans are sold. Specifically, upon the sale of loans, the amounts related to the mortgage servicing rights or residual interests are reclassified on the consolidated statement of financial condition from loans held for sale and are, therefore, a non-cash transaction. As a result, the Company will show these mortgage servicing rights and residual interests as non-cash transactions in the supplemental disclosures within the Consolidated Statement of Cash Flows.

As a result of the errors described above, the restatement affects the classification of these activities and the subtotals of cash flows from operating and investing activities presented in the affected Consolidated Statement of Cash Flows, but has no impact on the total Cash and Cash Equivalents for the nine months ended September 30, 2006. The restatement does not affect the Unaudited Consolidated Statement of Financial Condition, Consolidated Statement of Operations or Consolidated Statement of Stockholders Equity and Comprehensive Income (Loss) as of or for the period ended September 30, 2006.

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The effects of the restatement on the Consolidated Statement of Cash Flows for the nine month period ended September 30, 2006 are reflected in the following table.

		September 30, 2006 (Unaudited) (Dollars in Thousands)
Originally Reported:		
Proceeds from sales of loans available for sale	$	11,903,799
Origination and repurchase of loans available for sale, net of principal repayments		(12,401,103)
Net cash used in operating activities	$	(489,556)
Proceeds from sales of loans held for investment	$	
Origination and repurchase of portfolio loans, net of principal repayments		125,386
Increase in mortgage servicing rights		(175,141)
Net cash used in investing activities	$	647,021
As Restated:		
Proceeds from sales of loans available for sale	$	10,647,153
Origination and repurchase of loans available for sale, net of principal repayments		(11,835,950)
Net cash used in operating activities	$	(1,181,049)
Proceeds from sales of portfolio loans	$	1,256,646
Origination and repurchase of portfolio loans, net of principal repayments		(614,908)
Increase in mortgage servicing rights		
Net cash used in investing activities	$	1,338,514
Difference:		
Proceeds from sales of loans available for sale	$	1,256,646
Origination and repurchase of loans available for sale, net of principal repayments		(565,153)
Net cash used in operating activities	$	691,493
Proceeds from sales of portfolio loans	$	(1,256,646)
Origination and repurchase of portfolio loans, net of principal repayments		740,294
Increase in mortgage servicing rights		(175,141)
Net cash used in investing activities	$	(691,493)

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Where we say we, us, or our, we usually mean Flagstar Bancorp, Inc. In some cases, a reference to we, us, or will include our wholly-owned subsidiary Flagstar Bank, FSB, and Flagstar Capital Markets Corporation, its wholly-owned subsidiary, which we collectively refer to as the Bank.

General

Operations of the Bank are categorized into two business segments: banking and home lending. Each segment operates under the same banking charter, but is reported on a segmented basis for financial reporting purposes. For certain financial information concerning the results of operations of our banking and home lending operations, see Note 9 of the Notes to Consolidated Financial Statements, in Item 1, Financial Statements, herein.

Banking Operation. We provide a full range of banking services to consumers and small businesses in Michigan, Indiana and Georgia. Our banking operation involves the gathering of deposits and investing those deposits in duration-matched assets consisting primarily of mortgage loans originated by our home lending operation. The banking operation holds these loans in its loans held for investment portfolio in order to earn income based on the difference, or spread, between the interest earned on loans and investments and the interest paid for deposits and other borrowed funds. At September 30, 2007, we operated a network of 158 banking centers and provided banking services to approximately 119,400 customers. During the first nine months of 2007, we opened 7 banking centers, including 4 in Michigan and 3 in Georgia. During the remainder of 2007, we expect to open 3 additional branches in the Atlanta, Georgia area, 3 additional branches in Michigan, and 1 in Indiana.

Home Lending Operation. Our home lending operation originates, acquires, securitizes and sells residential mortgage loans on one-to-four family residences in order to generate transactional income. The home lending operation also services mortgage loans on a fee basis for others and occasionally sells mortgage servicing rights into the secondary market. Funding for our home lending operation is provided primarily by deposits and borrowings obtained by our banking operation.

Critical Accounting Policies

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, we have identified five policies that, due to the judgment, estimates and assumptions inherent in those policies, are critical to an understanding of our consolidated financial statements. These policies relate to: (a) the determination of our allowance for loan losses; (b) the valuation of our MSRs; (c) the valuation of our residuals; (d) the valuation of our derivative instruments; and (e) the determination of our secondary market reserve. We believe that the judgment, estimates and assumptions used in the preparation of our consolidated financial statements are appropriate given the factual circumstances at the time. However, given the sensitivity of our consolidated financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. For further information on our critical accounting policies, please refer to our Annual Report on Form 10-K for the year ended December 31, 2006, which is available on our website, **www.flagstar.com**, under the Investor Relations section, or on the website of the SEC, at **www.sec.gov**.

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Selected Financial Ratios
(Dollars in thousands, except share data)

	For the Three Months Ended September 30, 2007	For the Three Months Ended September 30, 2006	For the Nine Months Ended September 30, 2007	For the Nine Months Ended September 30, 2006
Return on average assets	(0.77)%	0.55%	(0.08)%	0.60%
Return on average equity	(17.08)%	10.10%	(1.57)%	12.23%
Efficiency ratio	133.5%	63.8%	85.2%	62.0%
Equity/assets ratio (average for the period)	4.51%	5.46%	4.79%	4.93%
Mortgage loans originated or purchased	$ 6,566,185	$ 4,633,986	$ 19,218,370	$ 13,882,989
Other loans originated or purchased	$ 262,415	$ 200,161	$ 785,169	$ 885,158
Mortgage loans sold	$ 5,955,396	$ 4,045,915	$ 16,975,645	$ 11,904,611
Interest rate spread Bank only[1]	1.35%	1.44%	1.29%	1.44%
Net interest margin Bank only[2]	1.52%	1.67%	1.45%	1.65%
Interest rate spread Consolidated[1]	1.27%	1.47%	1.29%	1.48%
Net interest margin Consolidated[2]	1.36%	1.54%	1.38%	1.57%
Dividend payout ratio	(18.8)%	39.7%	(197.3)%	41.9%
Average common shares outstanding	60,265	63,548	61,450	63,475
Average fully diluted shares outstanding	60,636	64,304	61,874	64,323
Charge-offs to average investment loans (annualized)	0.33%	0.18%	0.34%	0.19%

	September 30, 2007	June 30, 2007	December 31, 2006	September 30, 2006
Equity-to-assets ratio	4.40%	4.76%	5.24%	5.39%
Core capital ratio [3]	5.78%	6.04%	6.37%	6.52%
Total risk-based capital ratio [3]	10.65%	10.96%	11.55%	11.52%
Book value per share	$ 12.09	$ 12.78	$ 12.77	$ 12.82
Number of common shares outstanding	60,271	60,260	63,605	63,571
Mortgage loans serviced for others	$ 26,665,052	$ 21,508,835	$ 15,032,504	$ 14,829,396
Capitalized value of mortgage servicing rights	1.28%	1.24%	1.15%	1.02%
Ratio of allowance to non-performing loans	61.0%	53.8%	80.2%	77.1%
Ratio of allowance to loans held for investment	1.11%	0.70%	0.51%	0.48%
Ratio of non-performing assets to total assets	1.34%	1.18%	1.03%	1.05%
Number of banking centers	158	156	151	146
Number of home lending centers	151	73	76	85
Number of salaried employees	2,939	2,689	2,510	2,559
Number of commissioned employees	852	462	444	491

1 Interest rate spread is the difference

between the annualized average yield earned on average interest-earning assets for the period and the annualized average rate of interest paid on average interest-bearing liabilities for the period.

2 Net interest margin is the annualized effect of the net interest income divided by that period s average interest-earning assets.

3 Based on adjusted total assets for purposes of tangible capital and core capital, and risk-weighted assets for purposes of risk-based capital and total risk based capital. These ratios are applicable to the Bank only

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Results of Operations

Net (Loss) Earnings

Three months. Net loss for the three months ended September 30, 2007 was $(32.0) million ($(0.53) per share-diluted), a $52.8 million decrease from net earnings of $20.8 million ($0.32 per share-diluted) reported in the comparable 2006 period. The overall