FLAGSTAR BANCORP INC
Form 10-K/A
March 07, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K/A
Amendment No. 1

(Mark One)

o **ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15(D) OF THE SECURITITES EXCHANGE ACT OF 1933**

OR

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

OR

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

Commission File No.: 001-16577
FLAGSTAR BANCORP, INC.
(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)

Registrant s telephone number, including area code: **(248) 312-2000**
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act Yes o No þ

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 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

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

The estimated aggregate market value of the voting common stock held by non-affiliates of the registrant, computed by reference to the closing sale price ($15.96 per share) as reported on the New York Stock Exchange on June 30, 2006, was approximately $607.5 million. The registrant does not have any non-voting common equity shares.

As of February 23, 2007, 63,625,870 shares of the registrant s Common Stock, $0.01 par value, were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s Proxy Statement relating to its 2007 Annual Meeting of Stockholders have been incorporated into Part III of this Report on Form 10-K.

EXPLANATORY NOTE

On August 6, 2007, Flagstar Bancorp, Inc. (the Company) issued a press release and filed a related Current Report on Form 8-K with the Securities and Exchange Commission (SEC) in which it announced that it would be restating its previously issued Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004 and for the quarter ended March 31, 2007 in response to then-recently received comments from the SEC. The Company also announced that it was having continuing discussions with the SEC and that the ultimate resolution of those discussions might have an effect on the disclosures contained in our filings with the SEC.

This Amendment No. 1 (Form 10-K/A) to the Company s Annual Report on Form 10-K for the year ended December 31, 2006 that was originally filed with the SEC on March 1, 2007 (the Original Form 10-K) is being filed in response to and as a result of comments received from the staff of the SEC. It includes the previously announced restatement of the Company s Consolidated Statement of Cash Flows for each of the three years in the period ended December 31, 2006, as well as revisions and additional disclosures based on additional comments subsequently received from the SEC staff. All of these revisions and additional disclosures are described below.

Except as required to reflect the items described below, no other modifications or updates have been made to the Original Form 10-K. Information not affected by items described below remains unchanged and reflects the disclosures made at the time of, and as of the dates described in, the Original Form 10-K (including with respect to exhibits), and do not modify or update disclosures (including forward-looking statements) that may have been affected by events or changes in facts occurring after the filing date of the Original Form 10-K. Accordingly, this Form 10-K/A should be read in conjunction with the Company s filings made with the SEC subsequent to the filing of the Original Form 10-K, as information in such filings may have updated or superseded certain information contained in this Form 10-K/A.

<u>Part I. Item 1.</u>

Revised the disclosure presented in Part I, Item 1, Business Secondary Market Loan Sales and Securitization, to provide a more detailed description of our loan sale and securitization activities.

Revised the disclosure presented in Part I, Item 1, Business Other Business Activities Flagstar Credit, Inc., to provide information with respect to risks associated with our mortgage reinsurance operations.

<u>Part II. Item 7.</u>

Revised the disclosure in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Secondary Market Reserve, to provide additional information related to this critical accounting policy.

Revised the disclosure in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Provision for Loan Losses, to provide an expanded discussion of the period-to-period changes in our loan loss provision and our allowance for loan losses as well as changes and trends in the asset quality of our loan portfolios.

Clarified the disclosure presented in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Non-Interest Income Loan Fees and Charges and Non-Interest Expense SFAS 91, to remove the word certain to clarify our description of loan origination fees that are captured and amortized under Statement of Financial Accounting Standards (SFAS) 91.

Revised the presentation reflected in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Net Gain on Loan Sales, to provide information with respect to the components of our net gain on loan sales.

Expanded the presentation and disclosure of the facts and circumstances reflected in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Net Loss on Securities Available for Sale, resulting in the $6.1 million other-than-temporary impairment recognized on the private-label securitization completed in 2005, including our measurement process of the impairment.

Revised the presentation and disclosure in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Loans Available for Sale, to reconcile the amounts included within the roll forward of loans available for sale to amounts presented in the Statements of Cash Flows.

Clarified the disclosure presented in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Repurchased Assets, to emphasize that repurchased assets are loans that the Company reacquired as a result of representation and warranty issues related to loan sales or securitizations rather than as a result of non-performance at the time of repurchase.

Expanded the disclosure in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Secondary Market Reserve, to provide additional information with respect to the time frame during which the loan sales remain subject to such customary representations and warranties.

Expanded the disclosure in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources, to quantify the amount of dividends that can be paid by the Company s subsidiaries to the Company without regulatory approval.

Revised the disclosure in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources - Borrowings, to clarify our maximum allowable borrowings from the Federal Home Loan Bank of Indianapolis.

Part II. Item 8.

Revised the presentation and disclosure to correct the misclassification of cash flows from the sale of certain mortgage loans held for investment and inappropriately classified as operating activities within the Consolidated Statements of Cash Flows, and cash flows from certain mortgage loans originated as available for sale and inappropriately classified as investing activities. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Consolidated Statements of Cash Flows.

Revised the presentation and disclosure to correct the misclassification of the non-cash portion of mortgage servicing rights resulting from the sale or securitization of mortgage loans and the retention of residual interests as part of securitization activities to be included as part of the supplemental activity within the Consolidated Statements of Cash Flows. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Consolidated Statements of Cash Flows.

Revised the disclosure presented in Part II, Item 8, Financial Statements and Supplementary Data, Note 2 Summary of Significant Accounting Policies Loans, to remove the word certain to clarify how loan origination fees are captured and amortized under SFAS 91. Additionally, clarified how cash flows will be categorized with respect to loans that have been reclassified.

Expanded the disclosure in Part II, Item 8, Financial Statements and Supplementary Data, Note 2 Summary of Significant Accounting Policies Secondary Market Reserve, to provide additional information with respect to the time frame during which customary representations and warranties apply to our loan sales.

Expanded the presentation and disclosure of the facts and circumstances resulting in the $6.1 million other-than- temporary impairment recognized on the private-label securitization completed in 2005, including the manner in which we measure such impairment. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 5 Securities Available for Sale.

Expanded the presentation of the activity in the allowance for loan losses to disclose both gross charge-offs and related recoveries, rather than only net charge-offs. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 8 Loans Held for Investment.

Revised the presentation and disclosure presented in Part II, Item 8, Financial Statements and Supplementary Data, Note 9 Private-label Securitization Activity to include the weighted-average life of prepayable assets that we continue to hold as a result of securitization activities. Further, we revised the disclosure to include information required under SFAS 140, paragraph 17i(4), which includes a summary of collateral balances associated with servicing portfolio of loans sold, and of residual assets retained as a result of securitizations.

Revised the disclosure to specifically reflect the amounts of servicing fees, late fees and ancillary fees that are a part of the Company s Non-Interest Income within Consolidated Statements of Earnings for all years presented. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 13 Mortgage Servicing Rights. Additionally, we expanded the disclosure to reflect the weighted-average assumptions utilized during 2006 to capitalize our mortgage servicing rights including the assumption related to the weighted average life of our MSR s.

Expanded the presentation and disclosure to include the net gain or loss from cash flow hedges reclassified to earnings as required by SFAS 133, paragraph 47. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 23 - Accumulated Other Comprehensive Income.

Expanded the disclosure to include information required in SFAS 133, paragraph 45(b), related to derivatives classified as cash flow hedges to include, among other things, a description of where the net gain or loss is reported in our Consolidated Statement of Earnings and a description of events that result in the reclassification of amounts from accumulated other comprehensive income into earnings, including an estimate of gains or losses that are expected to be reclassified into earnings within the following twelve months. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 26 Derivative Financial Instruments.

Included additional disclosure to expand the description of our policy for issuing shares upon option exercise as required under SFAS 123(R), paragraph A240k. This revision is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 30 - Stock-Based Compensation Stock Option Plan.

Expanded the disclosure related to our cash-settled stock appreciation rights to include information required under SFAS 123(R), paragraph A240c, A240g, and A240h: vesting terms and the total number of shares authorized and awarded; the weighted-average grant date fair value of rights issued during the year; total compensation costs recognized in income and the related tax benefit recognized; and total compensation costs related to non-vested awards not yet recognized and the weighted-average period over which the costs will be recognized. This additional disclosure is included in Part II, Item 8, Financial Statements and Supplementary Data, Note 30 Stock-Based Compensation Cash-Settled Stock Appreciation Rights.

Expanded the disclosure to include a detailed description of the Company s restricted stock unit plan, disclosing the vesting terms and the total number of restricted stock units authorized to be awarded, as required under SFAS 123(R), paragraph A240a. This additional disclosure is included in Part II, Item 8, Financial Statements and Supplementary Data, Note 30 Stock-Based Compensation Restricted Stock Units.

Added a footnote to the consolidated financial statements to explain the restatement of our December 31, 2006, 2005 and 2004 Consolidated Statements of Cash Flows and to provide a reconciliation of the changes from the Originally Reported cash flows to the As Restated cash flows. This footnote is reflected in Part II, Item 8, Financial Statements and Supplementary Data, Note 33 Restatement of Consolidated Financial Statements.

Cautions Regarding 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 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 conditional verbs such as would, should, could, might, can, may or similar expressions. There are a number of important factors that co cause our 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 this Form 10-K. 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

ITEM 1. BUSINESS

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 (FCMC), its wholly-owned subsidiary, which we collectively refer to as the Bank.

General

The Company is a Michigan-based savings and loan holding company. Our business is primarily conducted through our principal subsidiary, Flagstar Bank, FSB (the Bank), a federally chartered stock savings bank. At December 31, 2006, our total assets were $15.5 billion, making us the largest publicly held savings bank in the Midwest and the 17th largest savings bank in the United States.

The Bank is a member of the Federal Home Loan Bank of Indianapolis (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).

At December 31, 2006, we operated 151 banking centers located in Michigan, Indiana and Georgia (of which 41 are located in retail stores such as Wal-Mart) and 76 home loan centers located in 20 states. This includes an additional 14 banking centers we opened during 2006, including eight in Georgia. Our plan over the next five years is to increase our earning asset base and banking center network. To do this, we plan to continue to add banking centers and grow our lending channels in an effort to expand our market share in the markets we serve and to penetrate new markets. Toward this goal, during 2007, we expect to expand our banking center network by up to 13 new banking centers, with seven in Georgia.

Our earnings are from our retail banking activities, which generate net interest income, and non-interest income from sales of residential mortgage loans to the secondary market, the servicing of loans for others, the sale of servicing rights related to mortgage loans serviced and fee-based services provided to our customers. Approximately 96% of our total loan production during 2006 represented mortgage loans and home equity lines of credit that were secured by first or second mortgages on single-family residences.

On May 30, 2006, we formed Flagstar Capital Markets Corporation (FCMC) as a wholly-owned subsidiary of the Bank. FCMC performs the capital market functions that were previously handled by the Bank. These functions include holding investment loans, purchasing securities, selling and securitizing mortgage loans, maintaining and selling mortgage servicing rights, developing new loan products, establishing pricing for mortgage loans to be acquired, providing for lock-in support, and managing the interest rate risk associated with these activities.

At December 31, 2006, we had 2,510 full-time equivalent salaried employees and 444 account executives and loan officers.

Operating Segments

Our business is comprised of two operating segments banking and home lending. Our banking operation offers a line of consumer and commercial financial products and services to individuals and to small and middle market businesses through a network of banking centers (i.e., our bank branches) in Michigan, Indiana, and Georgia. Our home lending operation originates, acquires, sells and services mortgage loans on one-to-four family residences. Each operating segment supports and complements the operations of the other, with funding for the home lending operation primarily provided by deposits and borrowings obtained through the banking operation. Financial information regarding our two operating segments is set forth in Note 28 to our consolidated financial statements included in this report under Item 8. Financial Statements and Supplementary Data. A more detailed discussion of our two operating segments is set forth below.

Banking Operation. Our banking operation collects deposits and offers a broad base of banking services to consumer and commercial customers. We collect deposits at our 151 banking centers and via the Internet. We also sell certificates of deposit through independent brokerage firms. We borrow funds by obtaining advances from the FHLB and by entering into repurchase agreements using as collateral our mortgage-backed securities that we hold as investments. The banking operation invests these funds in a variety of consumer and commercial loan products.

We have developed a variety of deposit products ranging in maturity from demand-type accounts to certificates with maturities of up to ten years, savings accounts and money market accounts. We primarily rely upon our network of strategically located banking centers, the quality and efficiency of our customer service, and our pricing policies to attract deposits.

In past years, our national accounts division garnered funds through nationwide advertising of deposit rates and the use of investment banking firms. Since 2005, we have not solicited any funds through the division as we have been able to access more attractive funding sources through FHLB advances, security repurchase agreements and other forms of deposits that provide the potential for a long term customer relationship.

While our primary investment vehicle is single-family first mortgage loans originated or acquired by our home lending operation, our banking operation offers consumer and commercial financial products and services to individuals and to small to middle market businesses. During the past three years, we have placed increasing emphasis on commercial real estate lending and on second mortgage lending as an add-on to our national mortgage lending platform. In 2006, we expanded our commercial real estate lending to add 17 states to diversify our lending activity beyond Michigan, Indiana and Georgia.

We offer the following consumer loan products through our banking operation:

second mortgage loans, including home-equity lines of credit;

automobile loans, including loans for used cars;

boat loans;

student loans; and

personal loans and lines of credit, both secured and unsecured.

During 2006, we originated a total of $1.1 billion in consumer loans versus $1.2 billion originated in 2005. At December 31, 2006, our consumer loan portfolio totaled $1.1 billion or 9.0% of our investment loan portfolio, and contained $715.2 million of second mortgage loans, $284.4 million of home equity lines of credit, and $93.8 million of various other consumer loans.

We also offer a full line of commercial loan products and banking services especially developed for our commercial customers. Among the commercial loan products we offer are the following:

business lines of credit, including warehouse lines of credit to other mortgage lenders;

loans secured by real estate; and

working capital loans.

Commercial loans are made on a secured or unsecured basis but a vast majority are also secured by personal guarantees. Assets providing collateral for secured commercial loans require an appraised value sufficient to satisfy our loan-to-value ratio requirements. We also generally require that our commercial customers maintain a minimum debt-service coverage ratio. In addition, we consider the creditworthiness and managerial ability of our borrowers, the enforceability and collectibility of any relevant guarantees and the quality of the collateral.

At December 31, 2006, our commercial real estate loan portfolio totaled $1.3 billion, or 14.6% of our investment loan portfolio, and our non-real estate commercial loan portfolio was $14.6 million, or 0.2% of our investment loan portfolio. At December 31, 2005, our commercial real estate portfolio totaled $995.4 million and our non-real estate commercial loan portfolio totaled $8.4 million, or 9.4% of our investment loan portfolio. During 2006, we originated $671.5 million of commercial loans versus $555.5 million in 2005.

We also offer warehouse lines of credit to other mortgage lenders. These lines allow the lender to fund the closing of a mortgage loan. Each extension or drawdown on the line is collateralized by a mortgage loan and in many cases we subsequently acquire the mortgage loan. These lines of credit are, in most cases, personally guaranteed by a qualified principal officer of the borrower. The aggregate amount of warehouse lines of credit granted to other mortgage lenders at December 31, 2006, was $1.2 billion, of which $291.7 million was outstanding at December 31, 2006. At December 31, 2005, $1.3 billion in warehouse lines of credit had been granted, of which $146.7 million was outstanding.

Our banking operation offers a variety of other value-added, fee-based banking services.

Home Lending Operation. Our home lending operation originates, acquires, sells and services single-family residential mortgage loans. The origination or acquisition of residential mortgage loans constitutes our most significant lending activity. At December 31, 2006, approximately 64.1% of our earning assets consisted of first mortgage loans on single-family residences.

During 2006, we were one of the country s leading mortgage loan originators. We utilize three production channels to originate or acquire mortgage loans Retail, Broker and Correspondent. Each production channel produces similar mortgage loan products and applies, in most instances, the same underwriting standards.

Retail. In a retail transaction, we originate the loan through our nationwide network of 76 home loan centers as well as from our 151 banking centers located in Michigan, Indiana and Georgia and our national call center located in Troy, Michigan. When we originate loans on a retail basis, we complete all the loan paperwork and other aspects of the lending process and fund the transaction ourselves. During 2006, we closed $2.1 billion of loans utilizing this origination channel, which equaled 11.7% of total originations as compared to $4.0 billion or 14.2% of total originations in 2005 and $3.9 billion or 11.5% of total originations in 2004.

Broker. In a broker transaction, an unaffiliated mortgage brokerage company completes all of the loan paperwork, but we supply the funding for the loan at closing (also known as table funding) and become the lender of record. At closing, the broker may receive an origination fee from the borrower and we may also pay the broker a fee to acquire the mortgage servicing rights on the loan. We currently have active broker relationships with over 5,000 mortgage brokerage companies located in all 50 states. Brokers remain our largest loan production channel. During 2006, we closed $9.0 billion utilizing this origination channel, which equaled 48.3% of total originations, as compared to $16.1 billion or 57.1% in 2005 and $19.7 billion or 57.9% in 2004.

Correspondent. In a correspondent transaction, an unaffiliated mortgage company completes all of the loan paperwork and also supplies the funding for the loan at closing. We acquire the loan after the mortgage company has funded the transaction, usually paying the mortgage company a market price for the loan plus a fee to acquire the mortgage servicing rights on the loan. We have active correspondent relationships with over 1000 mortgage companies located in all 50 states. During 2006, we closed $7.2 billion utilizing this origination channel, which equaled 40% of total originations versus the $8.1 billion or 28.7% originated in 2005 and $10.4 billion or 30.6% originated in 2004.

We maintain 12 sales support offices that assist our brokers and correspondents nationwide. We also continue to make increasing use of the Internet as a tool to facilitate the mortgage loan origination process through our broker and correspondent production channels. Our brokers and correspondents are able to register and lock loans, check the status of in-process inventory, deliver documents in electronic format, generate closing documents, and request funds through the Internet. During 2006, virtually all mortgage loans that closed, used the Internet in the completion of the mortgage origination or acquisition process. We expect to continue to utilize technology to streamline the mortgage origination process and bring service and convenience to our correspondent partners and customers.

We offer permanent residential mortgage loans, which are either fixed-rate or adjustable-rate loans with terms ranging up to forty years. These mortgage loans originated or acquired are made either for the purpose of purchasing a one-to-four family residence or the refinancing of an existing mortgage on a one-to-four family residence.

Underwriting. Mortgage loans acquired or originated by the home lending operation are underwritten on a loan-by-loan basis rather than on a pool basis. In general, mortgage loans produced through any of our production channels are reviewed by one of our in-house loan underwriters or by a contract underwriter employed by a mortgage insurance company. However, certain of our correspondents have delegated underwriting authority. Any loan not underwritten by a Flagstar employed underwriter must be warranted by the underwriter s employer, whether it is a mortgage insurance company or correspondent mortgage brokerage company.

We believe that our underwriting process, which relies on the electronic submission of data and images and is based on an imaging workflow process, allows for underwriting at a higher level of accuracy and timeliness than exists with processes that rely on paper submissions. We also provide our underwriters with integrated quality control tools, such as automated valuation models (AVMs), multiple fraud detection engines and the ability to electronically submit IRS Form 4506s, to ensure underwriters have the information that they need to make informed decisions. The process begins with the submission of an electronic application and an initial determination of eligibility. The application and required documents are then faxed or uploaded to our corporate underwriting department and all documents are identified by optical character recognition or our underwriting staff. The underwriter is responsible for checking the data integrity and reviewing credit. The file is then reviewed in accordance with the applicable guidelines established by us for the particular product. Quality control checks are performed by underwriting, as necessary using the tools outlined above, and a decision is made and notice communicated to the prospective borrower.

Mortgage Loans. All mortgage loans acquired or originated by our home lending operation are secured by a mortgage on a one-to-four family residential property. A large majority of our mortgage loan products conform to the respective underwriting guidelines established by Fannie Mae, Ginnie Mae or Freddie Mac, which we collectively refer to as the Agencies . We generally require that any first mortgage loan with a loan-to-value ratio in excess of 80% carry mortgage insurance. A loan-to-value ratio is the percentage that the original principal amount of a loan bears to the appraised value of the mortgaged property at the time of underwriting. In the case of a purchase money mortgage, we use the lower of the appraised value of the property or the purchase price of the property securing the loan in determining this ratio. We also verify the reasonableness of the appraised value of loans by utilizing an AVM. We generally require a lower loan-to-value ratio, and thus a higher down payment, for loans on homes that are not occupied as a principal residence by the borrower. In addition, all first mortgage loans originated are subject to requirements for title, flood, windstorm, fire, and hazard insurance. Real estate taxes are generally collected and held in escrow for disbursement. We are also protected against fire or casualty loss on home mortgage loans by a blanket mortgage impairment insurance policy that insures us when the mortgagor s insurance is inadequate.

Construction Loans. Our home lending operation also makes loans for the construction of one-to-four family residential housing throughout the United States, with a large concentration in our southern Michigan market area. These construction loans usually convert to permanent financing upon completion of construction. All construction loans are secured by a first lien on the property under construction. Loan proceeds are disbursed in increments as construction progresses and as inspections warrant. Construction/permanent loans may have adjustable or fixed interest rates and are underwritten in accordance with the same terms and requirements as permanent mortgages, except that during a construction period, generally up to nine months, the borrower is required to make interest-only monthly payments. Monthly payments of principal and interest commence one month from the date the loan is converted to permanent financing. Borrowers must satisfy all credit requirements that would apply to permanent mortgage loan financing prior to receiving construction financing for the subject property. During 2006, we originated a total of $114.8 million in construction loans versus $103.9 million originated in 2005 and $112.3 million originated in 2004. At December 31, 2006, our portfolio of loans held for investment included $64.5 million of loans secured by properties under construction, or 0.7% of total loans held for investment.

Secondary Market Loan Sales and Securitizations. The following table indicates the breakdown of our loan sales/securitizations by principle channel for the period as indicated:

	For the Year Ended December 31,		
	2006 Principal Sold %	2005 Principal Sold %	2004 Principal Sold %
Agency Securitizations	83.14%	89.56%	95.35%
Whole Loan Sales	14.57%	7.88%	4.65%
Private Securitizations	2.29%	2.56%	0.00%
Total	100.00%	100.00%	100.00%

We sell a majority of the mortgage loans we produce into the secondary market on a whole loan basis or by securitizing the loans into mortgage-backed securities. In general, we securitize our longer-term, fixed-rate loans for sale and hold the shorter duration and adjustable rate loans for investment.

Most of the mortgage loans that we sell are securitized through the Agencies. In an Agency securitization, we exchange mortgage loans that are owned by us for mortgage-backed securities that are guaranteed by Fannie Mae or Freddie Mac or insured through Ginnie Mae and are collateralized by the same mortgage loans that were exchanged. Most or all of these mortgage-backed securities may then be sold to secondary market investors, which may be the Agencies or other third parties in the secondary market. We receive cash payment for these securities upon the settlement dates of the respective sales, at which time we also transfer the related mortgage-backed securities to the purchaser.

We have also securitized a smaller portion of our mortgage loans through a process which we refer to as a private-label securitizations, to differentiate it from an Agency securitization. In our private-label securitizations, we sell mortgage loans to a wholly-owned bankruptcy remote special purpose entity, which then sells the mortgage loans to a separate, transaction-specific trust in exchange for cash and certain interests in the securitization trust and securitized mortgage loans. Each securitization trust issues and sells mortgage-backed securities to third party investors that are secured by payments on the mortgage loans. These securities are commonly rated by at least two of the nationally recognized statistical rating organizations. We have no obligation to provide credit support to either the third-party investors or the securitization trusts, although we are required to make certain servicing advances with respect to mortgage loans in the trusts. Neither the third-party investors nor the securitization trusts generally have recourse to our assets or us and have no ability to require us to repurchase their mortgage-backed securities. We do not guarantee any mortgage-backed securities issued by the securitization trusts. We do make certain customary representations and warranties concerning the mortgage loans as discussed below, and if we are found to have breached a representation or warranty, we could be required to repurchase the mortgage loan from the applicable securitization trust. Each securitization trust represents a qualifying special purpose entity , which meets the certain criteria of Statement of Financial Accounting Standards (SFAS) 140, and therefore is not consolidated for financial reporting purposes.

In addition to the cash we receive from the securitization of mortgage loans, we retain certain interests in the securitized mortgage loans and the securitization trusts. Such retained interests include residual interests, which arise as a result of our private-label securitizations, and mortgage servicing rights (MSR s), which can arise as a result of our Agency securitizations, our private-label securitizations, or both.

The residual interests created upon the issuance of private-label securitizations, represent the first loss position and are not typically rated by any nationally recognized statistical rating organization. The value of residual interests represents the present value of the future cash flows expected to be received by us from the excess cash flows created in the securitization transaction. Excess cash flows are dependent upon various factors, including estimated prepayment speeds, credit losses and over-collateralization requirements. Residual interests are not typically entitled to any cash flows unless the over-collateralization account, which represents the difference between the bond balance and the collateral underlying the security, has reached a certain level and unless certain expenses are paid. The over-collateralization requirement may increase if certain events occur, such as increases in delinquency rates or cumulative losses. If certain expenses are not paid or over-collateralization requirements are not met, the trustee applies cash flows to the over-collateralization account until such requirements are met and no excess cash flows would flow to the residual interests. A delay or reduction in the excess cash flows will result in a lower valuation of the residual interests.

Residual interests are designated by us as available-for-sale securities at the time of securitization and are periodically evaluated for impairment. These residual interests are marked to market with changes in the value recognized in other comprehensive income net of tax. If residual interests are deemed to be impaired and the impairment is other-than-temporary, the impairment is recognized in the current period earnings. We use an internally developed model to value the residual interest. The model takes into consideration the cash flow structure specific to each transaction, such as over-collateralization requirements and trigger events, and key valuation assumptions, including credit losses, prepayment rates and, to a lesser degree, discount rates. On an annual basis, the value of our residual interests is reviewed by an outside valuation expert.

When we sell or securitize mortgage loans, we may retain the servicing, or MSRs, of the mortgage loans. We may then sell these MSRs to other secondary market investors. In general, we do not sell the servicing rights to mortgage loans that we originate for our own portfolio or that we privately securitize. When we retain MSRs, we are entitled to receive a servicing fee equal to a specified percentage of the outstanding principal balance of the loans. We may also be entitled to receive additional servicing compensation, such as late payment fees.

When we sell mortgage loans, whether through Agency securitizations, private-label securitizations or on a whole loan basis, we make customary representations and warranties to the purchasers about various characteristics of each loan, such as the manner of origination, the nature and extent of underwriting standards applied and the types of documentation being provided. If a defect in the origination process is identified, we may be required to either repurchase the loan or indemnify the purchaser for losses it sustains on the loan. If there are no such defects, we have no liability to the purchaser for losses it may incur on such loan. We maintain a secondary market reserve to account for the expected losses related to loans we might be required to repurchase (or the indemnity payments we may have to make to purchasers). The secondary market reserve takes into account both our estimate of expected losses on loans sold during the current accounting period as well as adjustments to our previous estimates of expected losses on loans sold. In each case, these estimates are based on our most recent data regarding loan repurchases, actual credit losses on repurchased loans and recovery history, among other factors. Increases to the secondary market reserve for current loan sales reduce our net gain on loan sales. Adjustments to our previous estimates are recorded as an increase or decrease in our other fees and charges. The amount of our secondary market reserve equaled $24.2 million and $17.6 million at December 31, 2006 and 2005, respectively.

Loan Servicing. The home lending operation also services mortgage loans for others. Servicing residential mortgage loans for third parties generates fee income and represents a significant business activity for us. During 2006, 2005 and 2004, we serviced portfolios of mortgage loans that averaged $20.3 billion, $26.8 billion and

$26.4 billion, respectively. The servicing generated gross revenue of $82.6 million, $103.3 million and $106.2 million in 2006, 2005, and 2004, respectively. This revenue stream was offset by the amortization of $69.6 million, $94.5 million and $76.1 million in previously capitalized values of MSRs in 2006, 2005, and 2004, respectively. When a loan is prepaid or refinanced, any remaining MSR for that loan is fully amortized and therefore amortization expense in a period could increase at a greater rate than the increase in loan administration income. During a period of falling or low interest rates, the amount of amortization typically increases because of prepayments and refinancing of the underlying mortgage loans. During a period of higher or rising interest rates, payoffs and refinancing typically slows reducing the rate of amortization.

As part of our business model we occasionally sell MSRs into the secondary market if we determine that market prices provide us with an opportunity for appropriate profit. Over the past five years, we sold $130.6 billion of the MSRs. During 2006, we sold $27.6 billion of the MSRs. The MSRs are sold in separate transactions from the sale of the underlying loans. At the time of the sale we record a gain or loss on such sale based on the selling price of the MSRs less the carrying value and transaction costs. The market price of MSRs changes with demand and the general level of interest rates.

Other Business Activities

We conduct business through a number of wholly-owned subsidiaries in addition to the Bank.

Douglas Insurance Agency, Inc. Douglas Insurance Agency, Inc. (Douglas) acts as an agent for life insurance and health and casualty insurance companies. Douglas primary purpose is to act as the agent that provides group life and health insurance to the Company s employees. Douglas also acts as a broker with regard to certain insurance product offerings to employees and customers. Douglas activities are not material to our business.

Flagstar Credit, Inc. Flagstar Credit, Inc. (FCI) is a wholly-owned subsidiary of the Company that provides credit enhancement with respect to certain pools of mortgage loans underwritten and originated by us during each calendar year. With each of the pools, all of the primary risk associated with a pool is initially borne by one or more unaffiliated private mortgage insurance companies. A portion of the risk is then ceded to FCI by the primary insurance company, which remains principally liable for the entire amount of the primary risk. To effect this, the private mortgage insurance company provides loss coverage for all foreclosure losses up to the entire amount of the insured risk with respect to each pool of loans. The respective private mortgage insurance company then cedes a portion of that risk to FCI and pays FCI a corresponding portion of the related premium. The mortgage insurance company usually retains the portion of the insured risk ranging from 0% to 5% and from 10.01% to 100% of the insured risk. FCI s share of the total amount of the insured risk is an intermediate tranche of credit enhancement risk, which covers the 5.01% to 10% range and, therefore its maximum exposure at any time equals 5% of the insured risk of the insured pools. At December 31, 2006, FCI s maximum exposure amounted to $110.7 million. Pursuant to our individual agreements with the private mortgage insurance companies, we are obliged to maintain cash in a separately managed account for the benefit of these mortgage insurance companies to cover any losses experienced in the portion ceded to us. The amounts we maintain are determined periodically by these companies and reflect their overall assessment at that time of our probability of maximum loss related to our ceded portion and the related severity of such loss. Pursuant to these agreements, we are not obliged to provide any funds to the mortgage insurance companies to cover any losses in our ceded portion other than the funds we are required to maintain in this separately managed account. At December 31, 2006, this separately managed account had a balance of $23.3 million. However, we believe the actual risk of loss is much lower because the credit enhancement is provided on an aggregated pool basis rather than on an individual loan basis. Also, FCI s obligation is subordinated to the primary insurers, and we believe that the insured mortgage loans are fully collateralized. As such, while FCI does bear some risk in the structure, we believe FCI s actual risk exposure is minimal. As of December 31, 2006 and to date, no claim has yet been made against FCI on the mortgage loan credit enhancement it provides.

Subsequent to December 31, 2006, we formed a new reinsurance company called Flagstar Reinsurance Company (FRC) as a wholly-owned subsidiary of the Company. With the approval of each of the mortgage insurers, all of the assets of FCI were transferred to FRC effective October 1, 2007, all actual and contingent liabilities that FCI had at the time were assumed by FRC without any further recourse to FCI, and FRC succeeded to all rights and obligations of the agreements with the mortgage insurers. Following this transfer, FRC has continued the operations of FCI without change and FCI ceased operations.

Other Flagstar Subsidiaries. In addition to the Bank, Douglas and Credit, we have a number of wholly-owned subsidiaries that are inactive. We also own 7 statutory trusts that are not consolidated with our operations. For additional information, see Notes 2 and 17 of the Notes to the Consolidated Financial Statements, in Item 8. Financial Statements and Supplemental Data, herein.

Flagstar Bank. The Bank, our primary subsidiary, is a federally chartered, stock savings bank headquartered in Troy, Michigan. The Bank is the sole shareholder of Flagstar Intermediate Holding Company (IHC). IHC is the holding company for Flagstar LLC. The Bank is also the sole shareholder of FCMC. IHC s operations were discontinued in 2006.

Flagstar Capital Markets Corporation. FCMC is a wholly-owned subsidiary of the Bank and its functions include holding investment loans, purchasing securities, selling and securitizing mortgage loans, maintaining and selling mortgage servicing rights, developing new loan products, establishing pricing for mortgage loans to be acquired, providing for lock-in support, and managing interest rate risk associated with these activities.

Flagstar ABS LLC. Flagstar ABS LLC (ABS) is a bankruptcy remote special purpose entity that has been created to hold trust certificates in connection with our private securitization offerings.

Other Bank Subsidiaries. The Bank, in addition to IHC and FCMC, also wholly-owns several other subsidiaries, all of which are inactive at December 31, 2006.

Regulation and Supervision

Regulation and Supervision

Both the Company and the Bank are subject to regulation by the OTS. Also, the Bank is a member of the FHLB and our deposits are insured by the FDIC through the DIF. Accordingly, we are subject to an extensive regulatory framework which imposes restrictions on our activities, minimum capital requirements, lending and deposit restrictions and numerous other requirements primarily intended for the protection of depositors, federal deposit insurance funds and the banking system as a whole, rather than for the protection of shareholders and creditors. Many of these laws and regulations have undergone significant change in recent years and are likely to change in the future. Future legislative or regulatory change, or changes in enforcement practices or court rulings, may have a significant and potentially adverse impact on our operations and financial condition. Our non-bank financial subsidiaries are also subject to various federal and state laws and regulations.

Federal Home Loan Bank System. The primary purpose of the Federal Home Loan Banks (the FHLBs) is to provide funding to their members in the form of repayable advances for making housing loans as well as for affordable housing and community development lending. The FHLBs are generally able to make advances to their member institutions at interest rates that are lower than the members could otherwise obtain. The FHLB System consists of 12 regional FHLBs; each being federally chartered but privately owned by its member institutions. The Federal Housing Finance Board, a government agency, is generally responsible for regulating the FHLB System. The Bank is currently a member of the FHLB located in Indianapolis.

Holding Company Status and Acquisitions. We are a savings and loan holding company, as defined by federal law. We may not acquire control of another savings association unless the OTS approves such transaction and we may not be acquired by a company other than a bank holding company unless the OTS approves such transaction, or by an individual unless the OTS does not object after receiving notice. We may not be acquired by a bank holding company unless the Board of Governors of the Federal Reserve System (the Federal Reserve) approves such transaction. In any case, the public must have an opportunity to comment on any such proposed acquisition and the OTS or Federal Reserve must complete an application review. Without prior approval from the OTS, we may not acquire more than 5% of the voting stock of any savings institution. In addition, the federal Gramm-Leach-Bliley Act generally restricts any non-financial entity from acquiring us unless such non-financial entity was, or had submitted an application to become, a savings and loan holding company on or before May 4, 1999. Also, because we were a savings and loan holding company prior to that date, we may engage in non-financial activities and acquire non-financial subsidiaries.

Capital Adequacy. The Bank must maintain a minimum amount of capital to satisfy various regulatory capital requirements under OTS regulations and federal law. There is no such requirement that applies to the Company. Federal law and regulations establish five levels of capital compliance: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. As of December 31, 2006, the Bank met all capital requirements to which it was subject and satisfied the requirements to be treated as well-capitalized under OTS regulations. An institution is treated as well-capitalized if its ratio of total risk-based capital to risk-weighted assets is 10.0% or more, its ratio of Tier 1 capital to risk-weighted assets is 6.0% or more, its leverage ratio is 5.0% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In contrast, an institution is only considered to be adequately capitalized if its capital structure satisfies lesser required levels, such as a total risk-based capital ratio of not less than 8.0%, a Tier 1 risk-based capital ratio of not less than 4.0%, and (unless it is in the most highly-rated category) a leverage ratio of not less than 4.0%. Any institution that is neither well capitalized nor adequately capitalized will be considered undercapitalized. Any institution with a tangible equity ratio of 2.0% or less will be considered critically undercapitalized.

The various U.S. banking agencies and the Basel Committee on Banking Supervision are developing a new set of regulatory risk-based capital requirements that would apply to the 20 largest banks in the United States initially and to us soon afterwards. The Basel Committee on Banking Supervision is a committee established by the central bank governors of certain industrialized nations, including the United States. The new requirements are commonly referred to as Basel II or The New Basel Capital Accord. We are assessing the potential impact that The New Basel Capital Accord may have on our business practices as well as the broader competitive effects within the industry.

In October 2005, and subsequently revised in June 2006 and December 2006, the various U.S. banking agencies issued an advance rulemaking notice that contemplated possible modifications to the risk-based capital framework applicable to those domestic banking organizations that would not be affected by Basel II. These possible modifications, known colloquially as Basel 1A, are intended to avoid future competitive inequalities between Basel I and Basel II organizations and include: (i) increasing the number of risk-weight categories; (ii) expanding the use of external ratings for credit risk; (iii) expanding the range of collateral and guarantors to qualify for a lower risk weight; and (iv) basing residential mortgage risk ratings on loan-to-value ratios. The banking regulators indicated an intention to publish proposed rules for implementation of Basel I and Basel II in similar time frames, which we currently expect may occur during 2007.

Commercial Real Estate Lending Guidelines. In January 2006, federal banking regulators issued a joint interagency proposal on lending guidelines that would apply to commercial loans secured by real estate. Under the proposal, an institution would need to hold additional capital for regulatory purposes if its origination and holding of commercial real estate loans rise above certain asset levels and contain certain risk characteristics. In December 2006, the OTS issued its final version of those guidelines, which did not contain the asset level limits but were otherwise substantially unchanged. We do not believe these guidelines will materially affect our current operations.

Non-Traditional Lending Guidelines. In December 2005, the federal banking agencies, including the OTS, issued proposed lending guidelines that would effectively require increased capital for holding loans in its portfolio that were considered non-traditional. These guidelines were finalized in 2006 in substantially the same form. Under these guidelines, such loans included interest-only loans and payment option adjustable rate mortgage loans which permit a borrower to make regular payments less than the amount of the scheduled principal amortization, thereby increasing the loan balance (known as negative amortization). At December 31, 2006, approximately 47.4% of our residential mortgage loans that we held for investment were comprised of adjustable rate loans with interest-only payments required during the first ten years. We do not anticipate that these guidelines will materially affect our current operations.

Payment of Dividends. The Company is a legal entity separate and distinct from the Bank and our non-banking subsidiaries. The Company s principal sources of funds are cash dividends paid by the Bank and other subsidiaries, investment income and borrowings. Federal laws limit the amount of dividends or other capital distributions that the Bank may pay us. The Bank has an internal policy to remain well-capitalized under OTS capital adequacy regulations (discussed immediately above). Accordingly, the Bank does not currently expect to pay dividends to the Company if such payment would result in the Bank not being well capitalized. In addition, the Bank must file a notice with the OTS at least 30 days before it may pay a dividend to the Company.

FDIC Assessment. The FDIC insures the deposits of the Bank and such insurance is backed by the full faith and credit of the United States government. Through March 31, 2006, the FDIC administered two separate deposit insurance funds, the Bank Insurance Fund (the BIF) and the Savings Association Insurance Fund (the SAIF). The SAIF was the deposit insurance fund for most savings associations, including the Bank. In February 2006, President Bush signed into law the Federal Deposit Insurance Reform Conforming Amendments Act of 2005, which among other things allowed for the merger of the BIF and the SAIF to form the DIF. Under FDIC guidelines issued in November 2006, the Bank s premiums would increase, as would those of other banks, to increase the capitalization of the DIF. For 2007, the assessment is currently expected to increase to approximately $5.0 million, before any credits, as compared to $1.1 million in 2006.

If the Bank were to fail, claims for administrative expenses of the receiver and for deposits in all of our branches (including claims of the FDIC as subrogee) would have priority over the claims of general unsecured creditors and shareholders.

Affiliate Transaction Restrictions. The Bank is subject to the affiliate and insider transaction rules applicable to member banks of the Federal Reserve System as well as additional limitations imposed by the OTS. These provisions prohibit or limit a banking institution from extending credit to, or entering into certain transactions with, affiliates, principal stockholders, directors and executive officers of the banking institution and its affiliates.

Federal Reserve, Consumer and Other Regulation. Numerous regulations promulgated by the Federal Reserve affect the business operations of the Bank. These include regulations relating to equal credit opportunity, electronic fund transfers, collection of checks, truth in lending, truth in savings and availability of funds.

Under Federal Reserve Board regulations, the Bank is required to maintain a reserve against its transaction accounts (primarily interest-bearing and non-interest-bearing checking accounts). Because reserves must generally be maintained in cash or in non-interest-bearing accounts, the effect of the reserve requirements is to increase the Bank s cost of funds.

The federal Gramm-Leach-Bliley Act includes provisions that protect consumers from the unauthorized transfer and use of their nonpublic personal information by financial institutions. In addition, states are permitted under the Gramm-Leach-Bliley Act to have their own privacy laws, which may offer greater protection to consumers than the Gramm-Leach-Bliley Act. Numerous states in which we do business have enacted such laws.

The USA PATRIOT Act, which was enacted following the events of September 11, 2001, includes numerous provisions designed to detect and prevent international money laundering and to block terrorist access to the U.S. financial system. We have established policies and procedures intended to fully comply with the USA PATRIOT Act s provisions, as well as other aspects of anti-money laundering legislation and the Bank Secrecy Act.

Consumer Protection Laws and Regulations. Examination and enforcement by bank regulatory agencies for non-compliance with consumer protection laws and their implementing regulations have become more intense in nature. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below.

Federal regulations requires extra disclosures and consumer protections to borrowers for certain lending practices. The term predatory lending, much like the terms safety and soundness and, unfair and deceptive practices, is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. Predatory lending typically involves at least one, and perhaps all three, of the following elements:

- Making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation (asset-based lending);
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (loan flipping); and/or
- Engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Privacy policies are required by federal banking regulations which limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to those rules, financial institutions must provide:

- Initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- Annual notices of their privacy policies to current customers; and
- A reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

These privacy protections affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, or FACT Act, requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and gives consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with FACT Act, financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer s election to opt out would be applicable for at least five years.

The Check Clearing for the 21st Century Act, or Check 21, facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a substitute check, which is the legal equivalent of an original check. Check 21 does not require banks to create substitute checks or accept checks electronically; however, it does require banks to accept a legally equivalent substitute check in place of an original. In addition to its issuance of regulations governing substitute checks, the Federal Reserve has issued final rules governing the treatment of remotely created checks (sometimes referred to as demand drafts) and electronic check conversion transactions (involving checks that are converted to electronic transactions by merchants and other payees).

The Equal Credit Opportunity Act, or ECOA, generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act, or TILA, is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The Fair Housing Act, or FH Act, regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The Home Mortgage Disclosure Act, or HMDA, grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a fair lending aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes. In 2004, the Federal Reserve Board amended regulations issued under HMDA to require the reporting of certain pricing data with respect to higher-priced mortgage loans. This expanded reporting is being reviewed by federal banking agencies and others from a fair lending perspective.

The Real Estate Settlement Procedures Act, or RESPA, requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts.

Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with the FACT Act, ECOA, TILA, FH Act, HMDA and RESPA generally, the Bank may incur additional compliance costs or be required to expend additional funds for investments in its local community.

Community Reinvestment Act. The Community Reinvestment Act (CRA) requires the Bank to ascertain and help meet the credit needs of the communities it serves, including low- to moderate-income neighborhoods, while maintaining safe and sound banking practices. The primary federal regulatory agency assigns one of four possible ratings to an institution s CRA performance and is required to make public an institution s rating and written evaluation. The four possible ratings of meeting community credit needs are outstanding, satisfactory, needs to improve and substantial noncompliance. In 2006, the Bank received an outstanding CRA rating from the OTS.

Regulatory Enforcement. The OTS and the FDIC may take regulatory enforcement actions against any of their regulated institutions that do not operate in accordance with applicable regulations, policies and directives. Proceedings may be instituted against any banking institution, or any institution-affiliated party, such as a director, officer, employee, agent or controlling person, who engages in unsafe and unsound practices, including violations of applicable laws and regulations. Both the OTS and the FDIC have authority under various circumstances to appoint a receiver or conservator for an insured institution that it regulates to issue cease and desist orders, to obtain injunctions restraining or prohibiting unsafe or unsound practices, to revalue assets and to require the establishment of reserves. The FDIC has additional authority to terminate insurance of accounts, after notice and hearing, upon a finding that the insured institution is or has engaged in any unsafe or unsound practice that has not been corrected, is operating in an unsafe or unsound condition or has violated any applicable law, regulation, rule, or order of, or condition imposed by, the FDIC.

Environmental Regulation

Our business and properties are subject to federal and state laws and regulations governing environmental matters, including the regulation of hazardous substances and wastes. For example, under the federal Comprehensive Environmental Response, Compensation, and Liability Act and similar state laws, owners and operators of contaminated properties may be liable for the costs of cleaning up hazardous substances without regard to whether such persons actually caused the contamination. Such laws may affect us both as an owner or former owner of properties used in or held for our business, and as a secured lender on property that is found to contain hazardous substances or wastes. If we foreclose on a defaulted mortgage loan to recover our investment in such mortgage loan, we may be subject to environmental liabilities in connection with the underlying real property. We may also have to pay for the entire cost of any removal and clean up without the contribution of any other third parties. These liabilities and costs could exceed the fair value of the real property and may make the property impossible to sell. Our general policy is to obtain an environmental assessment prior to foreclosing on commercial property. We may elect not to foreclose on properties that contain such hazardous substances or wastes, thereby limiting, and in some instances precluding, the liquidation of such properties.

Competition

We face substantial competition in attracting deposits and making loans. Our most direct competition for deposits has historically come from other savings institutions, commercial banks and credit unions in our local market areas. Money market funds and full-service securities brokerage firms also compete with us for deposits. We compete for deposits by offering high quality and convenient banking services at a large number of convenient locations, including longer banking hours and sit-down banking in which a customer is served at a desk rather than in a teller line. We also compete by offering competitive interest rates on our deposit products.

From a lending perspective, there are a large number of institutions offering mortgage loans, consumer loans and commercial loans, including many mortgage lenders that operate on a national scale, as well as local savings institutions, commercial banks, and other lenders. We compete by offering competitive interest rates, fees and other loan terms and by offering efficient and rapid service.

Additional information

Our executive offices are located at 5151 Corporate Drive, Troy, Michigan 48098, and our telephone number is (248) 312-2000. Our stock is traded on the New York Stock Exchange under the symbol FBC .

We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act available free of charge on our website at www.flagstar.com as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission. These reports are also available without charge on the SEC website, at www.sec.gov.

ITEM 1A. RISK FACTORS

Our financial condition and results of operations may be adversely affected by various factors, many of which are beyond our control. These risk factors include the following:

General business, economic and political conditions may significantly affect our earnings.

Our business and earnings are sensitive to general business and economic conditions in the United States. These conditions include short-term and long-term interest rates, inflation, recession, unemployment, real estate values, fluctuations in both debt and equity capital markets, the value of the U.S. dollar as compared to foreign currencies, and the strength of the U.S. economy, as well as the local economies in which we conduct business. If any of these conditions worsen, our business and earnings could be adversely affected. For example, business and economic conditions that negatively impact household incomes could decrease the demand for our home loans and increase the number of customers who become delinquent or default on their loans; or, a rising interest rate environment could decrease the demand for loans.

In addition, our business and earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies. We are particularly affected by the policies of the Federal Reserve, which regulates the supply of money and credit in the United States. The Federal Reserve s policies influence the size of the mortgage origination market, which significantly impacts the earnings of our mortgage lending operation and the value of our investment in MSRs and other retained interests. The Federal Reserve s policies also influence the yield on our interest-earning assets and the cost of our interest-bearing liabilities. Changes in those policies are beyond our control and difficult to predict and could have a material adverse effect on our business, results of operations and financial condition.

If we cannot effectively manage the impact of the volatility of interest rates, our earnings could be adversely affected.

Our main objective in managing interest rate risk is to maximize the benefit and minimize the adverse effect of changes in interest rates on our earnings over an extended period of time. In managing these risks, we look at, among other things, yield curves and hedging strategies. As such, our interest rate risk management strategies may result in significant earnings volatility in the short term because the market value of our assets and related hedges may be significantly impacted either positively or negatively by unanticipated variations in interest rates.

Our profitability depends in substantial part on our net interest margin, which is the difference between the rates we receive on loans made to others and investments and the rates we pay for deposits and other sources of funds. Our profitability also depends in substantial part on the volume of loan originations and the related fees received in our mortgage banking operations. Our net interest margin and our volume of mortgage originations will depend on many factors that are partly or entirely outside our control, including competition, federal economic, monetary and fiscal policies, and economic conditions generally. Historically, net interest margin and the mortgage origination volumes for the Bank and for other financial institutions have widened and narrowed in response to these and other factors. Our goal has been to structure our asset and liability management strategies to maximize the benefit of changes in market interest rate on our net interest margin and revenues related to mortgage origination volume. However, we can not give any assurance that a sudden or significant change in prevailing interest rates will not have a material adverse effect on our operating results.

Since June 30, 2004, the U.S. Federal Reserve has increased short-term interest rates significantly, while long-term rates have increased more moderately, resulting in a flattened and then inverted yield curve. Our profitability levels on loan sales have been adversely affected by the rapidly rising interest rate environment. We manage the strategic interest rate risk in our home lending operation primarily through the natural counterbalance of our loan production and servicing operations. Increasing interest rates may decrease our mortgage loan originations and sales. Generally, the volume of mortgage loan originations is inversely related to the level of long-term interest rates. During periods of low interest rates, a significant number of our customers may elect to refinance their mortgages (i.e., pay off their existing higher rate mortgage loans with new mortgage loans obtained at lower interest rates). Our profitability levels and those of others in the mortgage banking industry have generally been strongest during periods of low and/or declining interest rates, as we have historically been able to sell the resulting increased volume of loans into the secondary market at a gain. We have also benefited from periods of wide spreads between short and long term interest rates. If interest rates rise after we fix a price for a loan or commitment but before we close or sell such loan, the value of the loan will decrease and the amount we receive from selling the loan may be less than its cost to originate.

When interest rates fluctuate, repricing risks arise from the timing difference in the maturity and/or repricing of assets, liabilities and off-balance sheet positions. While such repricing mismatches are fundamental to our business, they can expose us to fluctuations in income and economic value as interest rates vary. Our interest rate risk management strategies do not completely eliminate repricing risk. A significant amount of our deposit liabilities are higher-priced jumbo accounts which we attribute to the current highly competitive market for deposits and, in part, to our practice of using attractive deposit rates when we open new banking centers in new markets. These account holders are more sensitive to the interest rate paid on their account than most depositors. There is no guarantee that in a changing rate environment we will be able to retain all of these depositors accounts. We also call on local municipal agencies as another source for deposit funding. While a valuable source of liquidity, we believe that municipal deposits are usually extremely rate sensitive and, therefore, prone to withdrawal if higher interest rates are offered elsewhere. Because of the interest rate sensitivity of these depositors, there is no guarantee that in a changing rate environment we will be able to retain all funds in these accounts.

Changes in interest rates may cause a mismatch in our mortgage origination flow of loans, or pipeline and adversely affect our profitability. In our mortgage banking operation, we are exposed to interest rate risk from the time we commit to an interest rate on a mortgage loan application through the time we sell or commit to sell the mortgage loan. On a daily basis, we analyze various economic and market factors to estimate the percentage of mortgage loans we expect to sell for delivery at a future date. The amount of loans that we commit to sell is based in part on our expectation of the pull-through percentage, which is the ratio of mortgage loans closed divided by the number of mortgage loans on which we have issued binding commitments (and thereby locked in the interest rate) but have not yet closed (pipeline loans) . If interest rates change in an unanticipated fashion, the actual percentage of pipeline loans that close may differ from the projected percentage. A mismatch of commitments to fund mortgage loans and commitments to sell mortgage loans may have an adverse effect on the results of operations in any such period. For instance, we may not have made commitments to sell these additional pipeline loans and therefore may incur significant losses upon their sale if the market rate of interest is higher than the mortgage interest rate to which we committed on such additional pipeline loans. Alternatively, we may have made commitments to sell more loans than actually closed or at prices that are no longer profitable to us. Our profitability may be adversely affected to the extent our economic hedging strategy for pipeline loans is not effective.

Our allowance for possible loan losses may be insufficient.

We maintain an allowance for possible loan losses, which is a reserve established through a provision for possible loan losses charged to expense, that represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management s continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for possible loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside our control, may require an increase in the allowance for possible loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for possible loan losses we will need additional provisions to increase the allowance for possible loan losses. Any increases in the allowance for possible loan losses will result in a decrease in net earnings and, possibly, capital, and may have a material adverse effect on our financial condition and results of operations.

Our secondary market reserve for losses on repurchased loans could be insufficient.

We currently maintain a secondary market reserve, which is a liability on our statement of financial condition, to reflect our best estimate of expected losses that we have incurred on loans that we have sold or securitized into the secondary market and must subsequently repurchase or with respect to which we must indemnify the purchasers because of violations of customary representations and warranties. Increases to this reserve for current loan sales reduce our net gain on loan sales, with adjustments to our previous estimates recorded as an increase or decrease to our other fees and charges. The level of the reserve reflects management s continuing evaluation of loss experience on repurchased loans, recovery history, and present economic conditions, among other things. The determination of the appropriate level of the secondary market reserve inherently involves a high degree of subjectivity and requires us to make significant estimates of repurchase risks and expected losses. Both the assumptions and estimates used could change materially, resulting in a level of reserve that is less than actual losses. Further, our bank regulators periodically review us and may, in their discretion and based on their own judgment, which may differ from that of management, require us to increase the amount of the reserve through additional provisions. Such increases will result in a reduction in net earnings and could have an adverse effect on our statement of financial condition and results of operations.

The value of our mortgage servicing rights varies with changes in interest rates.

The market value of, and earnings from, our mortgage loan servicing portfolio may be adversely affected by declines in interest rates. When mortgage rates rise we would generally expect payoffs in our servicing portfolio to decline, which increases the fair value of our MSR. When mortgage interest rates decline mortgage loan prepayments tend to increase as customers refinance their loans. When this happens, the income stream from our current mortgage loan servicing portfolio may decline. In that case, we may be required to amortize the portfolio over a shorter period of time or reduce the carrying value of our mortgage loan servicing portfolio.

Our home lending profitability could be significantly reduced if we are not able to resell mortgages.

Currently, we sell a substantial portion of the mortgage loans we originate. The profitability of our mortgage banking operations depends in large part upon our ability to aggregate a high volume of loans and to sell them in the secondary market at a gain. Thus, we are dependent upon (1) the existence of an active secondary market and (2) our ability to profitably sell loans or securities into that market.

Our ability to sell mortgage loans readily is dependent upon the availability of an active secondary market for single-family mortgage loans, which in turn depends in part upon the continuation of programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae and other institutional and non-institutional investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. Some of the largest participants in the secondary market, including Fannie Mae, Freddie Mac and Ginnie Mae, are government-sponsored enterprises whose activities are governed by federal law. Any future changes in laws that significantly affect the activity of such government-sponsored enterprises could, in turn, adversely affect our operations.

In addition, our ability to sell mortgage loans readily is dependent upon our ability to remain eligible for the programs offered by Fannie Mae, Freddie Mac, Ginnie Mae and other institutional and non-institutional investors. We expect to remain eligible to participate in such programs but any significant impairment of our eligibility could materially and adversely affect our operations. Further, the criteria for loans to be accepted under such programs may be changed from time to time by the sponsoring entity. The profitability of participating in specific programs may vary depending on a number of factors, including our administrative costs of originating and purchasing qualifying loans.

There are increased risks involved with commercial real estate and commercial business lending activities.

In recent years, we have emphasized the origination of commercial real estate and commercial business loans. At December 31, 2006, our balance of commercial loans was $1.3 billion, which was 14.7% of loans held for investment and 8.4% of total assets. Loans collateralized by commercial real estate generally involve a greater degree of credit risk than single-family residential mortgage loans and carry larger loan balances. This increased credit risk is a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income-producing properties, and the greater difficulty of evaluating and monitoring these types of loans.

Furthermore, the repayment of loans collateralized by commercial real estate is typically dependent upon the successful operation of the related real estate property. If the cash flow from the project is reduced, the borrower s ability to repay the loan may be impaired. Other commercial business loans generally have a greater credit risk than residential mortgage loans as well. Conversely residential mortgage loans are generally made on the basis of the borrower s ability to make repayment from his or her employment or other income, and are secured by real property whose value tends to be more easily ascertainable.

As a result, the availability of funds for the repayment of commercial business loans may depend substantially on the success of the business itself. Further, any collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value.

We have substantial risks in connection with securitizations and loan sales.

Securitization and loan sale transactions comprise a significant source of our overall funding. Our sales channels include whole loan sales, sales to government-sponsored enterprises and sales through private-label securitizations. Private-label securitizations, sponsored by us, involve transfers of loans to off-balance sheet qualifying special purpose entities who in turn issue securities to third parties. Residuals, which are retained interests created in a mortgage loan securitization, typically represent the first loss position and are not typically rated by a nationally recognized rating agency. If we hold the residuals, we are at risk for the initial losses that might occur with these securitizations.

In a securitization transaction, we may recognize a gain on sale resulting from related residuals and/or servicing rights in the securitized pool of loans when we sell or securitize the assets. The values assigned to the residuals and/or servicing assets depends upon certain assumptions that we make about the future performance of the securitized loan portfolio, including the level of credit losses and the rate of prepayments. If actual credit losses or prepayment rates differ from the original assumptions, the value of the residuals and/or servicing assets may decrease materially, possibly resulting in a charge against earnings. The value of the residuals and/or servicing assets may also decrease materially as a result of changes in market interest rates.

Changes in the volume of assets securitized or sold due to our inability to access the asset-backed securitization markets or other funding sources could have a material adverse effect on our business, financial condition and results of operations. Decreases in the value of the residuals and/or servicing assets in securitizations that we have completed due to market interest rate fluctuations or higher than expected credit losses on prepayments also could have a material adverse effect on our business, financial condition and results of operations.

In addition, we retain limited contractual exposure from the sale of mortgage loans. We make standard representations and warranties to the transferee in connection with all such dispositions. These representations and warranties do not insure the transferee against credit risk associated with the transferred loans, but if individual mortgage loans are found not to have complied with the associated representations and warranties, we may be required to repurchase the loans from the transferee or to indemnify the transferee against any losses on the loans. We have established a secondary market reserve for losses that arise in connection with representations and warranties for loans sold.

Our ability to borrow funds and raise capital could be limited, which could adversely affect our earnings.

Our ability to make mortgage loans depends largely on our ability to secure funds on terms acceptable to us. Our primary sources of funds to meet our financing needs include loan sales and securitizations, deposits, borrowings from the FHLB, borrowings from investment and commercial banks through repurchase agreements, and capital-raising activities. Our ability to maintain borrowing facilities is subject to renewal of these facilities. If we are unable to renew any of these financing arrangements or arrange for new financing on terms acceptable to us, or if we default on any of the restrictions imposed upon us by our borrowing facilities, then we may have to reduce the number of loans we are able to originate for sale in the secondary market or for our own investment. A sudden and significant reduction in loan originations that occurs as a result could adversely impact our earnings. There is no guarantee that we will be able to adequately access capital markets when or if a need for additional capital arises.

Certain changes in the economy could effect our financial, funding, and liquidity risks.

Management of liquidity and related risks is a key function for our business. Our funding requirements currently are met principally by deposits, financing from the FHLB and other financial institutions, and financing using capital markets. In general, the costs of our funding directly impact our costs of doing business and, therefore, can positively or negatively affect our financial results.

A number of factors could make such funding more difficult, more expensive, or unavailable on affordable terms, including, but not limited to, our financial results, organizational changes, adverse impacts on our reputation, changes in the activities of our business partners, disruptions in the capital markets, specific events that adversely impact the financial services industry, counterparty availability, changes affecting our loan portfolio or other assets, changes affecting our corporate and regulatory structure, interest rate fluctuations, ratings agency actions, general economic conditions, and the legal, regulatory, accounting and tax environments governing our funding transactions. In addition, our ability to raise funds is strongly affected by the general state of the U.S. and world economies and financial markets, and may become increasingly difficult due to economic and other factors.

Regulatory laws or rules that establish minimum capital levels, regulate deposit insurance, and govern related funding matters for banks could be changed in a manner that could increase our overall cost of capital and thus reduce our earnings.

We may not be able to replace key members of senior management or attract and retain qualified relationship managers in the future.

We depend on the services of existing senior management to carry out our business and investment strategies. As we expand and as we continue to refine our business model, we will need to continue to attract and retain additional senior management and to recruit qualified individuals to succeed existing key personnel that leave our employ. In addition, as we continue to grow our business and plan to continue to expand our locations, products and services, we will need to continue to attract and retain qualified banking personnel. Competition for such personnel is especially keen in our geographic market areas and competition for the best people in most businesses in which we engage can be intense. If we are unable to attract and retain talented people our business could suffer. The loss of the services of any senior management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our results of operations, financial conditions and prospects.

The network and computer systems on which we depend could fail or experience a security breach.

Our computer systems could be vulnerable to unforeseen problems. Because we conduct part of our business over the Internet and outsource several critical functions to third parties, operations will depend on the ability, as well as that of third-party service providers, to protect computer systems and network infrastructure against damage from fire, power loss, telecommunications failure, physical break-ins or similar catastrophic events. Any damage or failure that causes interruptions in operations could have a material adverse effect on our business, financial condition and results of operations.

In addition, a significant barrier to online financial transactions is the secure transmission of confidential information over public networks. Our Internet banking system relies on encryption and authentication technology to provide the security and authentication necessary to effect secure transmission of confidential information. Advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms our third-party service providers use to protect customer transaction data. If any such compromise of security were to occur, it could have a material adverse effect on our business, financial condition and results of operations.

Market acceptance of Internet banking depends substantially on widespread adoption of the Internet for general commercial and financial services transactions. If another provider of commercial services through the Internet were to suffer damage from physical break-in, security breach or other disruptive problems caused by the Internet or other users, the growth and public acceptance of the Internet for commercial transactions could suffer. This type of event could deter our potential customers or cause customers to leave us and thereby materially and adversely affect our business, financial condition and results of operations.

Our business is highly regulated.

The banking industry in general is extensively regulated at the federal and state levels. Insured depository institutions and their holding companies are subject to comprehensive regulation and supervision by financial regulatory authorities covering all aspects of their organization, management and operations. The OTS is the primary regulator of the Bank and its affiliated entities. In addition to its regulatory powers, the OTS also has significant enforcement authority that it can use to address unsafe and unsound banking practices, violations of laws, and capital and operational deficiencies. Such regulation and supervision are intended primarily for the protection of the insurance fund and for our depositors and borrowers, and are not intended to protect the interests of investors in our common stock. Further, the Bank s business is affected by consumer protection laws and regulation at the state and federal level, including a variety of consumer protection provisions, many of which provide for a private right of action and pose a risk of class action lawsuits. Accordingly, the actions of governmental authorities responsible for regulatory, fiscal and monetary affairs can have a significant and immediate impact on the activities of financial services firms such as ours. See further information in Item 1. Business Regulation and Supervision.

Our business has volatile earnings because it operates based on a multi-year cycle.

The home lending segment of our business is a cyclical business that generally performs better in a low interest rate environment with a yield curve that is lower at the shorter time frames and higher at the longer time frames. In addition, other external factors, including tax laws, the strength of various segments of the economy and demographics of our lending markets, could influence the level of demand for mortgage loans. Gain on sale of loans is a large component of our revenue and would be adversely impacted by a significant decrease in the volume of our mortgage loan originations.

Geographic concentrations pose a higher risk of loan losses.

A significant portion of our mortgage loan portfolio is geographically concentrated in certain states, including California, Michigan, Florida, Washington, Colorado, Texas and Arizona, which collectively represent approximately 65.4% of our mortgage loans held for investment balance at December 31, 2006. In addition, 76.9% of our commercial real estate loans are in Michigan. Any adverse economic conditions in these markets could cause the number of loans originated to decrease, likely resulting in a corresponding decline in revenues and an increase in credit risk. Also, we could be adversely affected by business disruptions triggered by natural disasters, or acts of war or terrorism.

A large percentage of our loans are collateralized by real estate, and an adverse change in the real estate market may result in losses and adversely affect our portfolio.

Approximately 79.7% or our investment loan portfolio as of December 31, 2006, was comprised of loans collateralized by real estate. The collateral in each case provides an alternate source of repayment if the borrower defaults and may deteriorate in value during the time the credit is extended. An adverse change in the economy affecting real estate values generally or in our primary markets specifically could significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. In the event of a default with respect to any of these loans, amounts received upon sale of the collateral may be insufficient to recover outstanding principal and interest on the loan. As a result, our profitability could be negatively impacted by an adverse change in the real estate market.

A significant part of our business strategy involves adding new branch locations, and our failure to grow may adversely affect our business, prospects, results of operations and financial condition.

Our expansion strategy consists principally of adding new branch locations in Michigan, Indiana and Georgia growth areas that complement our existing branch network. While we anticipate that this expansion strategy will enhance long-term shareholder value, it is possible that our branch expansion strategy may not become accretive to our earnings over the short term. New branches generally require a significant initial capital investment and take several years to become profitable. New branches require a significant upfront investment for land and building expenses. Accordingly, we anticipate that, in the short term, net income will be negatively affected as we incur significant capital expenditures and noninterest expense in opening and operating new branches before the new branches can produce sufficient net interest income to offset the increased expense. In addition, the need to use capital to fund de novo branching may limit our ability to pay or increase dividends on our common stock. There also is implementation risk associated with new branches. Numerous factors will determine whether our branch expansion strategy will be successful, such as our ability to select suitable branch locations, real estate acquisition costs, competition, interest rates, managerial resources, our ability to hire and retain qualified personnel, the effectiveness of our marketing strategy and our ability to attract deposits.

The state income tax structure in Michigan or other states could change significantly causing a reduction in our profitability.

A significant portion of our business is conducted in Michigan and we are likely to continue to have a significant portion of our business in Michigan. During 2006, the Michigan legislature repealed the single business tax that served as a significant source of revenue for the state. It is currently unknown as to what type of taxing structure will replace Michigan s single business tax. As such, should the replacement to the single business tax be less favorable to companies like ours, our profitability could be adversely impacted. Similarly, the taxing structure or the interpretation of other state regulation concerning tax could change in a manner that would be less favorable to us and therefore adversely impact our profitability.

We are subject to heightened regulatory scrutiny with respect to bank secrecy and anti-money laundering statutes and regulations.

Recently, regulators have intensified their focus on the USA PATRIOT Act s anti-money laundering and Bank Secrecy Act compliance requirements. There is also increased scrutiny of our compliance with the rules enforced by the Office of Foreign Assets Control. In order to comply with regulations, guidelines and examination procedures in this area, we have been required to adopt new policies and procedures and to install new systems. We can not be certain that the policies, procedures and systems we have in place are flawless. Therefore, there is no assurance that in every instance we are in full compliance with these requirements.

Other Risk Factors.

The above description of risk factors is not exhaustive. Other risk factors are described elsewhere herein as well as in other reports and documents that we file with or furnish to the SEC. Other factors that could also cause results to differ from our expectations may not be described in any such report or document. Each of these factors could by itself, or together with one or more other factors, adversely affect our business, results of operations and/or financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

At December 31, 2006, we operated from the headquarters in Troy, Michigan, a regional office in Jackson, Michigan, and a regional office in Atlanta, Georgia, 151 banking centers in Michigan, Indiana and Georgia and 76 home lending centers in 20 states. We also maintain 12 wholesale lending offices. Our banking centers consist of 76 free-standing office buildings, 41 in-store banking centers and 35 centers in buildings in which there are other tenants, typically strip malls and similar retail centers.

We own the buildings and land for 75 of our offices, own the building but lease the land for one of our offices, and lease the remaining 163 offices. The offices that we lease have lease expiration dates ranging from 2007 to 2017.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we are party to legal proceedings incident to our business. However, at December 31, 2006, there were no legal proceedings that we anticipate will have a material adverse effect on us. See Notes 3 and 21 of the Notes to Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No items were submitted during the fourth quarter of the year covered by this Report to be voted on by security holders through a solicitation of proxies or otherwise.

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock trades on the New York Stock Exchange under the trading symbol FBC. At December 31, 2006, there were 63,604,590 shares of our common stock outstanding held by approximately 18,300 shareholders of record.

Dividends

The following table shows the high and low closing prices for the Company s common stock during each calendar quarter during 2006 and 2005, and the cash dividends per common share declared during each such calendar quarter. We declare dividends on our common stock on a quarterly basis and currently expect to continue to do so. However, the amount of and nature of any dividends declared on our common stock in the future will be determined by our Board of Directors in their sole discretion.

Quarter Ending	Highest Closing Price	Lowest Closing Price	Dividends Declared In the Period
December 31, 2006	$15.46	$14.31	$0.15
September 30, 2006	$16.29	$14.01	$0.15
June 30, 2006	$16.96	$14.67	$0.15
March 31, 2006	$15.60	$14.08	$0.15
December 31, 2005	$16.07	$12.69	$0.15
September 30, 2005	$19.26	$16.00	$0.25
June 30, 2005	$20.39	$18.10	$0.25
March 31, 2005	$22.69	$19.18	$0.25

Equity Compensation Plan Information

The following table sets forth certain information with respect to securities to be issued under the Company s equity compensation plans as of December 31, 2006.

Plan Category	Number of Securities to Be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity Compensation Plans approved by security holders (1)	3,029,737	$ 13.79	5,289,094
Total	3,029,737	$ 13.79	5,289,094

(1) Consists of our 2006 Equity Incentive Plan,

which provides for the granting of stock options, incentive stock options, cash-settled stock appreciation rights, restricted stock units, performance shares and performance units and other awards. The 2006 Equity Incentive Plan consolidated, merged, amended and restated our 1997 Employees and Directors Stock Option Plan, 2000 Stock Incentive Plan, and 1997 Incentive Compensation Plan. Awards still outstanding under any of the prior plans will continue to be governed by their respective terms. Under the 2006 Equity Incentive Plan, the exercise price of any option granted must be at least equal to the fair value of our common stock on the date of grant. Non-qualified stock options granted to directors expire five years from the date of grant. Grants other than non-qualified stock options have term limits set by the board of directors in the applicable agreement. Stock appreciation rights expire seven years from the date of grant. All securities remaining for future issuance represent option and stock awards available for award under the 2006 Equity Incentive Plan.

Sale of Unregistered Securities

The Company made no unregistered sales of its common stock during the quarter ended December 31, 2006.

Issuer Purchases of Equity Securities

The following table shows shares of our common stock that we purchased in the fourth quarter of 2006.

Period	Total Number of Shares Purchased (a)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value (in millions) of Shares that May Yet Be Purchased Under the Plans or Programs (b)
October 2006				
November 2006	240	$14.76		
December 2006				
Total	240	$14.76		

(a) All of the shares purchased by the Company during the fourth quarter of 2006 were related to awards of our common stock given to our employees in recognition of their 10th anniversary with the Company.

(b) On January 31, 2007, the Company announced that our board of directors adopted a Stock Repurchase

Program under which we are authorized to repurchase up to $40.0 million worth of our outstanding common stock. On February 27, 2007, the Company announced that the board of directors had increased the authorized repurchase amount from $40.0 million to $50.0 million. This program expires in twelve months from January 31, 2007. No shares have been repurchased under this plan.

ITEM 6. SELECTED FINANCIAL DATA

	2006	2005	2004	2003	2002
	For the Years Ended December 31,				
	(In thousands, except per share data)				
Summary of Consolidated Statements of Earnings:					
Interest income	$800,866	$708,663	$563,437	$503,068	$441,796
Interest expense	585,919	462,393	340,146	308,482	263,880
Net interest income	214,947	246,270	223,291	194,586	177,916
Provision for loan losses	25,450	18,876	16,077	20,081	27,126
Net interest income after provision for loan losses	189,497	227,394	207,214	174,505	150,790
Other income	202,161	159,448	256,121	465,877	242,737
Operating and administrative expenses	275,637	262,887	243,005	252,915	226,121
Earnings before federal income tax provision	116,021	123,955	220,330	387,467	167,406
Provision for federal income taxes	40,819	44,090	77,592	135,481	59,280
Earnings before a change in accounting principle	75,202	79,865	142,738	251,986	108,126
Cumulative effect of a change in accounting principle					18,716
Net earnings	$ 75,202	$ 79,865	$142,738	$251,986	$126,842
Earnings per share before a change in accounting principle					
Basic	$ 1.18	$ 1.29	$ 2.34	$ 4.21	$ 1.85
Diluted	$ 1.17	$ 1.25	$ 2.22	$ 3.95	$ 1.75
Earnings per share from cumulative effect of a change in accounting principle					
Basic					$ 0.32
Diluted					$ 0.30
Net earnings per share basic	$ 1.18	$ 1.29	$ 2.34	$ 4.21	$ 2.17
Net earnings per share diluted	$ 1.17	$ 1.25	$ 2.22	$ 3.95	$ 2.05
Dividends per common share	$ 0.60	$ 0.90	$ 1.00	$ 0.50	$ 0.12
Dividend payout ratio	51%	70%	43%	11%	7%

	At or for the Years Ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
Summary of Consolidated Statements of Financial Condition:					
Total assets	$15,497,205	$15,075,430	$13,143,014	$10,553,246	$ 8,195,840
Mortgage-backed securities held to maturity	1,565,420	1,414,986	20,710	30,678	39,110
Loans receivable	12,128,480	12,349,865	12,065,465	9,599,803	7,287,338
Mortgage servicing rights	173,288	315,678	187,975	260,128	230,756
Total deposits	7,379,295	7,979,000	7,379,655	5,680,167	4,373,889
FHLB advances	5,407,000	4,225,000	4,090,000	3,246,000	2,222,000
Security repurchase agreements	990,806	1,060,097			
Stockholders equity	812,234	771,883	728,954	638,801	405,430
Other Financial and Statistical Data					
Tangible capital ratio	6.37%	6.26%	6.19%	7.34%	6.61%
Core capital ratio	6.37%	6.26%	6.19%	7.34%	6.61%
Total risk-based capital ratio	11.55%	11.09%	10.97%	13.30%	11.81%
Equity-to-assets ratio (at the end of the period)	5.24%	5.12%	5.54%	6.05%	4.95%
Equity-to-assets ratio (average for the period)	5.29%	5.07%	5.68%	5.17%	4.68%
Book value per share	$ 12.77	$ 12.21	$ 11.88	$ 10.53	$ 6.85
Shares outstanding	63,605	63,208	61,358	60,675	59,190
Average shares outstanding	63,588	62,128	61,057	59,811	58,350
Mortgage loans originated or purchased	$18,966,354	$28,244,561	$34,248,988	$56,550,735	$43,391,116
Other loans originated or purchased	1,241,588	1,706,246	995,429	609,092	388,006
Loans sold	16,370,925	23,451,430	28,937,576	51,922,757	40,495,894
Mortgage loans serviced for others	15,032,504	29,648,088	21,354,724	30,395,079	21,586,797
Capitalized value of mortgage servicing rights	1.15%	1.06%	0.88%	0.86%	1.07%
Interest rate spread consolidated	1.42%	1.74%	1.87%	2.01%	2.76%
Net interest margin consolidated	1.54%	1.82%	1.99%	2.16%	2.80%
	1.41%	1.68%	1.85%	1.91%	2.68%

Interest rate spread bank only					
Net interest margin bank only	1.63%	1.88%	2.08%	2.40%	3.00%
Return on average assets	0.49%	0.54%	1.17%	2.50%	1.76%
Return on average equity	9.42%	10.66%	20.60%	48.35%	37.61%
Efficiency ratio	66.1%	64.8%	50.7%	38.3%	53.8%
Net charge off ratio	0.20%	0.16%	0.16%	0.35%	0.51%
Ratio of allowance to investment loans	0.51%	0.37%	0.36%	0.55%	0.99%
Ratio of non-performing assets to total assets	1.03%	0.98%	0.99%	1.01%	1.51%
Ratio of allowance to non-performing loans	80.2%	60.7%	67.2%	64.9%	57.9%
Number of banking centers	151	137	120	98	86
Number of home loan centers	76	101	112	128	92

Note: All per share data has been restated for the 2 for 1 stock split on May 15, 2003, and for the 3 for 2 stock split completed on May 31, 2002.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

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 28 of the Notes to Consolidated Financial Statements, in Item 8, 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 December 31, 2006, we operated a network of 151 banking centers and provided banking services to approximately 143,000 customers. We continue to focus on expanding our branch network in order to increase our access to retail deposit funding sources. As we open new branches, we believe that the growth in deposits will continue over time. During 2006, we opened 14 banking centers, including eight banking centers in Georgia. During 2007, we expect to open seven additional branches in the Atlanta, Georgia area and six branches in Michigan.

Home Lending Operation. Our home lending operation originates, securitizes and sells residential mortgage loans in order to generate transactional income. The home lending operation also services mortgage loans on a fee basis for others and 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.

The following tables present certain financial information concerning the results of operations of our banking operation and home lending operation during the past three years.

BANKING OPERATION

	At or for the Years Ended December 31,		
	2006	**2005**	**2004**
		(In thousands)	
Net interest income	$ 159,255	$ 185,276	$ 175,403
Net gain on sale revenue			
Other income	31,353	55,813	63,227
Earnings before federal taxes	59,728	123,726	135,080
Identifiable assets	14,939,341	14,176,340	12,136,082

HOME LENDING OPERATION

	At or for the Years Ended December 31,		
	2006	**2005**	**2004**
		(In thousands)	
Net interest income	$ 55,692	$ 60,994	$ 47,888
Net gain on sale revenue	135,002	81,737	169,559
Other income	35,806	21,898	23,335
Earnings before federal taxes	56,293	229	85,250
Identifiable assets	3,597,864	2,379,090	2,245,932

Net Earnings Summary

Our net earnings for 2006 of $75.2 million ($1.17 per diluted share) represents a 5.9% decrease from the $79.9 million ($1.25 per diluted share) we achieved in 2005 and a decrease of 47.3% from the $142.7 million ($2.22 per diluted share) earned in 2004. The net earnings during 2006 were affected by the following factors:

Lower net interest income due to the increase in the average interest rate that we paid on our deposits and interest-bearing liabilities offset by average higher interest rate that we earned on our interest-earning assets.

A decrease in loan fees and charges which was a result of a reduction in loan originations. During the year ended December 31, 2006, loan originations were down 35.3% compared to 2005. To a large degree, the decrease in loan originations during 2006 was attributable to a decline in mortgage refinancings in the overall market as a result of stabilizing or increasing interest rates on single family mortgage loans.

Higher gain on sales of MSRs due to higher volume of sales and improved pricing.

Lower gain on loan sales due to decreased volume and more competitive pricing.

Higher overhead costs in our banking group attributable in part to the 14 additional banking centers that were opened during the year.

A reduction in overhead costs in our home lending operation due to reduction in the number of salaried and commissioned personnel in response to decreased loan demand.

See Results of Operations, below.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with U.S. GAAP and reflect general practices within our industry. Application of these principles requires management to make estimates or judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates are based on information available to management as of the date of the consolidated financial statements. Accordingly, as this information changes, future financial statements could reflect different estimates or judgments. Certain policies inherently have a greater reliance on the use of estimates, and as such have a greater possibility of producing results that could be materially different than originally reported. The most significant accounting policies followed by us are presented in Note 2 to the consolidated financial statements included in Item 8 herein. These policies, along with the disclosures presented in the other financial statement notes and other information presented herein, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how these values are determined. Management views critical accounting policies to be those that are highly dependent on subjective or complex judgments, estimates or assumptions, and where changes in those estimates and assumptions could have a significant impact on our consolidated financial statements. Management currently views the determination of the allowance for loan losses, the valuation of MSRs, the valuation of residuals, the valuation of derivative instruments, and the determination of the secondary market reserve to be our critical accounting policies.

Allowance for Loan Losses. The allowance for loan losses represents management s estimate of probable losses that are inherent in our loans held for investment portfolio, but which have not yet been realized as of the date of our consolidated statement of financial condition. We recognize these losses when (a) available information indicates that it is probable that a loss has occurred and (b) the amount of the loss can be reasonably estimated. We believe that the accounting estimates related to the allowance for loan losses are critical because they require us to make subjective and complex judgments about the effect of matters that are inherently uncertain. As a result, subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses. Our methodology for assessing the adequacy of the allowance involves a significant amount of judgment based on various factors such as general economic and business conditions, credit quality and collateral value trends, loan concentrations, recent trends in our loss experience, new product initiatives and other variables. Although management believes its process for determining the allowance for loan losses adequately considers all of the factors that could potentially result in loan losses, the process includes subjective elements and may be susceptible to significant change. To the extent actual outcomes differ from management estimates, additional provision for loan losses could be required that could adversely affect earnings or financial position in future periods.

Valuation of Mortgage Servicing Rights. When our home lending operation sells mortgage loans in the secondary market it usually retains the right to continue to service these loans and earn a servicing fee. At the time the loan is sold on a servicing retained basis, we record the mortgage servicing right as an asset at its fair value. Determining the fair value of MSRs involves a calculation of the present value of a set of market driven and MSR specific cash flows. MSRs do not trade in an active market with readily observable market prices. However, the market price of MSRs are generally a function of demand

and interest rates. When mortgage interest rates decline, mortgage loan prepayments usually increase as customers refinance their loans. When this happens, the income stream from a MSR portfolio will decline. In that case, we may be required to amortize the portfolio over a shorter period of time or reduce the carrying value of our MSR portfolio. Accordingly, we must make assumptions about future interest rates and other market conditions in order to estimate the current fair value our MSR portfolio. On an ongoing basis, we compare our fair value estimates to observable market data where available. On an annual basis, the value of our MSR portfolio is reviewed by an outside valuation expert. MSRs are recorded at the lower of carrying cost or fair market value.

From time to time, we sell some of these MSRs to unaffiliated purchasers in transactions that are separate from the sale of the underlying loans. At the time of the sale, we record a gain or loss based on the selling price of the MSRs less our carrying value and associated transaction costs.

Valuation of Residuals. Residuals are created upon the issuance of private-label securitizations. Residuals represent the first loss position and are not typically rated by the nationally recognized agencies. The value of residuals represents the present value of the future cash flows expected to be received by us from the excess cash flows created in the securitization transaction. In general, future cash flows are estimated by taking the coupon rate of the loans underlying the transaction less the interest rate paid to the investors, less contractually specified servicing and trustee fees adjusting for the effect of estimated prepayments and credit losses.

Cash flows are also dependent upon various restrictions and conditions specified in each transaction. For example, residual securities are not typically entitled to any cash flows unless over-collateralization has reached a certain level. The over-collateralization represents the difference between the bond balance and the collateral underlying security. A sample of an over-collateralization structure may require 2% of the original collateral balance for 36 months. At month 37, it may require 4%, but on a declining balance basis. Due to prepayments, that 4% requirement is generally less than the 2% required on the original balance. In addition, the transaction may include an over-collateralization trigger event, the occurrence of which may require the over-collateralization to be increased. An example of such trigger event is delinquency rates or cumulative losses on the underlying collateral that exceed stated levels. If over-collateralization targets were not met, the trustee would apply cash flows that would otherwise flow to the residual security until such targets are met. A delay or reduction in the cash flows received will result in a lower valuation of the residual.

Residuals are designated as available-for-sale securities at the time of securitization and are periodically evaluated for impairment. These residuals are marked to market with changes in the value recognized in other comprehensive income net of tax. If the security is deemed to be impaired and the impairment is other-than-temporary, the impairment is recognized in the current period earnings. We use an internally developed model to value the residuals. The model takes into consideration the cash flow structure specific to each transaction (such as over-collateralization requirements and trigger events). The key valuation assumptions include credit losses, prepayment rates and, to a lesser degree, discount rates. On an annual basis, the value of our residuals is reviewed by an outside valuation expert.

Valuation of Derivative Instruments. We utilize certain derivative instruments in the ordinary course of our business to manage our exposure to changes in interest rates. These derivative instruments include forward sale commitments and interest rate swaps. We also issue interest rate lock commitments to borrowers in connection with single family mortgage loan originations. We recognize all derivative instruments on our consolidated statement of financial position at fair value. The valuation of derivative instruments is considered critical because many are valued using discounted cash flow modeling techniques in the absence of market value quotes. Therefore, we must make estimates regarding the amount and timing of future cash flows, which are susceptible to significant change in future periods based on changes in interest rates. Our interest rate assumptions are based on current yield curves, forward yield curves and various other factors. Internally generated valuations are compared to third party data where available to validate the accuracy of our valuation models.

Derivative instruments may be designated as either fair value or cash flow hedges under hedge accounting principles or may be undesignated. A hedge of the exposure to changes in the fair value of a recognized asset, liability or unrecognized firm commitment is referred to as a fair value hedge. A hedge of the exposure to the variability of cash flows from a recognized asset, liability or forecasted transaction is referred to as a cash flow hedge. In the case of a qualifying fair value hedge, changes in the value of the derivative instruments that are highly effective are recognized in current earnings along with the changes in value of the designated hedged item. In the case of a qualifying cash flow hedge, changes in the value of the derivative instruments that are highly effective are recognized in accumulated other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative s change in fair value is recognized through earnings. Derivatives that are non-designated hedges are adjusted to fair value through earnings. At December 31, 2005, and throughout 2006, we had no derivatives designated as fair value hedges.

Secondary Market Reserve. We sell most of the residential mortgage loans that we originate into the secondary mortgage market. When we sell mortgage loans we make customary representations and warranties to the purchasers about various characteristics of each loan, such as the manner of origination, the nature and extent of underwriting standards applied and the types of documentation being provided. Typically these representations are in place for the life of the loan. If a defect in the origination process is identified, we may be required to either repurchase the loan or indemnify the purchaser for losses it sustains on the loan. If there are no such defects, we have no liability to the purchaser for losses it may incur on such loan. We maintain a secondary market reserve to account for the expected credit losses related to loans we may be required to repurchase (or the indemnity payments we may have to make to purchasers). The secondary market reserve takes into account both our estimate of expected losses on loans sold during the current accounting period, as well as adjustments to our previous estimates of expected losses on loans sold. In each case, these estimates are based on our most recent data regarding loan repurchases, actual credit losses on repurchased loans and recovery history, among other factors. Increases to the secondary market reserve for current loan sales reduce our net gain on loan sales. Adjustments to our previous estimates are recorded as an increase or decrease in our other fees and charges.

Like our other critical accounting policies, our secondary market reserve is highly dependent on subjective and complex judgments and assumptions. We began to specifically account for this risk in 2003 and have continued to enhance our estimation process and adjust our assumptions. Our assumptions are affected by factors both internal and external in nature. Internal factors include, among other things, level of loan sales, as well as to whom the loans are sold, improvements to technology in the underwriting process, expectation of credit loss on repurchased loans, expectation of loss from indemnification payments made to loan purchasers, the expectation of the mix between repurchased loans and indemnifications, our success rate at appealing repurchase demands and our ability to recover any losses from third parties. External factors that may affect our estimate includes, among other things, the overall economic condition in the housing market, the economic condition of borrowers, the political environment at investor agencies and the overall U.S. and world economy. Many of the factors are beyond our control and lend to judgments that are susceptible to change.

Results of Operations

Net Interest Income

2006. During 2006, we recognized $214.9 million in net interest income, which represented a decrease of 12.7% compared to the $246.3 million reported in 2005. Net interest income represented 51.5% of our total revenue in 2006 as compared to 60.7% in 2005. Net interest income is primarily the dollar value of the average yield we earn on the average balances of our interest-earning assets, less the dollar value of the average cost of funds we incur on the average balances of our interest-bearing liabilities. At December 31, 2006, we had an average balance of $14.0 billion of interest-earning assets, of which approximately $12.2 billion were loans receivable. Interest income recorded on these loans included the amortization of net premiums and net deferred loan origination costs. Partially offsetting the increase in earning assets was an increase in our cost of funds. Our interest-earning assets are funded with deposits and other short-term liabilities, primarily borrowings from the FHLB and security repurchase agreements. Typically, there is a spread between the long-term rates we earn on these mortgage loans and the short-term rates we pay on our funding sources. During 2006, the spread between these interest rates narrowed and then inverted, as short-term rates increased faster than the increase in long-term rates. The average cost of interest-bearing liabilities increased 23.8%, from 3.49% during 2005 to 4.32% in 2006, while the average yield on interest-earning assets increased only 9.8%, from 5.23% during 2005 to 5.74% in 2006. As a result, our interest rate spread during 2006 was 1.42% at year-end. The compression of our interest rate spread during the year caused our interest rate margin for 2006 to decrease to 1.54% from 1.82% during 2005. The adverse effect of the spread compression was offset in part by the increase in our ratio of interest-earning assets to interest-bearing liabilities, from 102% in 2005 to 103% in 2006. The Bank recorded an interest rate margin of 1.63% in 2006, as compared to 1.88% in 2005.

2005. During 2005, we recognized $246.3 million in net interest income, which represented an increase of 10.3% compared to the $223.3 million reported in 2004. Net interest income represented 60.7% of our total revenue in 2005 as compared to 46.6% in 2004. Net interest income is primarily the dollar value of the average yield we earn on the average balances of our interest-earning assets, less the dollar value of the average cost of funds we incur on the average balances of our interest-bearing liabilities. At December 31, 2005, we had an average balance of $13.6 billion of interest-earning assets, of which approximately $13.1 billion were loans receivable. Interest income recorded on these loans included the amortization of net premiums and net deferred loan origination costs. Partially offsetting the increase in earning assets was an increase in our cost of funds. Our interest-earning assets are funded with deposits and other short-term liabilities, primarily borrowings from the FHLB and security repurchase agreements. Typically, there is a spread between the long-term rates we earn on these mortgage loans and the short-term rates we pay on our funding sources. During 2005, the spread between these interest rates narrowed as short-term rates increased. The average cost of interest-bearing liabilities increased 10.4% from 3.16%, during 2004 to 3.49% in 2005, while the average yield on interest-earning assets increased only 4.0%, from 5.03% during 2004 to 5.23% in 2005. As a result, our interest rate spread during 2005 was 1.74% at year-end. The compression of our interest rate spread during the year caused our interest rate margin for 2005 to decrease to 1.82% from 1.99% during 2004. This is also reflected in the decline in our ratio of interest-earning assets to interest-bearing liabilities, from 104% in 2004 to 102% in 2005. The Bank recorded an interest rate margin of 1.88% in 2005, as compared to 2.08% in 2004.

The following table presents interest income from average earning assets, expressed in dollars and yields, and interest expense on average interest-bearing liabilities, expressed in dollars and rates. Interest income from earning assets includes the $28.3 million, $29.6 million and $15.8 million of amortization of net premiums and net deferred loan origination costs in 2006, 2005 and 2004, respectively. Non-accruing loans were included in the average loans outstanding.

	For the Years Ended December 31,								
	2006			2005			2004		
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
	(In thousands)								
Interest-Earning Assets:									
Loans receivable, net	$ 12,166,346	$ 711,037	5.84%	$ 13,128,224	$ 688,791	5.25%	$ 11,103,829	$ 559,902	5.04%
Mortgaged backed securities	1,555,930	77,607	4.99%	370,405	19,019	5.13%	25,893	1,459	5.63%
Other	229,117	12,222	5.33%	51,737	853	1.65%	66,627	2,076	3.12%
Total interest-earning assets	13,951,393	$ 800,866	5.74%	13,550,366	$ 708,663	5.23%	11,196,349	$ 563,437	5.03%
Other assets	1,330,755			1,240,143			1,002,029		
Total assets	$ 15,282,148			$ 14,790,509			$ 12,198,378		
Interest-Bearing Liabilities:									
Deposits	$ 8,030,276	$ 331,516	4.13%	$ 7,971,506	$ 253,292	3.18%	$ 6,724,568	$ 167,765	2.49%
FHLB advances	4,270,660	187,756	4.40%	4,742,079	182,377	3.85%	3,631,851	143,914	3.96%
Security repurchase agreements	1,028,916	52,389	5.09%	187,585	7,953	4.24%			
Other	232,149	14,258	6.14%	347,224	18,771	5.41%	413,913	28,467	6.88%
Total interest-bearing liabilities	$ 13,562,001	$ 585,919	4.32%	$ 13,248,394	$ 462,393	3.49%	$ 10,770,332	$ 340,146	3.16%
Other liabilities	921,655			792,781			734,994		
Stockholders equity	798,492			749,334			693,052		
Total liabilities and stockholders equity	$ 15,282,148			$ 14,790,509			$ 12,198,378		

Net interest-earning assets	$ 389,392	$ 301,972	$ 426,017
Net interest income	$ 214,947	$ 246,270	$ 223,291
Interest rate spread(1)	1.42%	1.74%	1.87%
Net interest margin (2)	1.54%	1.82%	1.99%
Ratio of average interest- earning assets to interest-bearing liabilities	103%	102%	104%

(1) Interest rate spread is the difference between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities.

(2) Net interest margin is net interest income divided by average interest-earning assets.

Rate/Volume Analysis

The following table presents the dollar amount of changes in interest income and interest expense for the components of interest earning assets and interest-bearing liabilities that are presented in the preceding table. The table below distinguishes between the changes related to average outstanding balances (changes in volume while holding the initial rate constant) and the changes related to average interest rates (changes in average rates while holding the initial balance constant). Changes attributable to both a change in volume and a change in rates were included as changes in rate.

	For the Years Ended December 31,					
	2006 Versus 2005 Increase (Decrease) Due to:			2005 Versus 2004 Increase (Decrease) Due to:		
	Rate	Volume	Total	Rate	Volume	Total
	(In millions)					
Interest-Earning Assets:						
Loans receivable, net	$ 72.7	$(50.5)	$ 22.2	$ 26.9	$102.0	$128.9
Mortgage-backed securities	(2.2)	60.8	58.6	(1.9)	19.4	17.5
Other	8.4	2.9	11.3	(0.6)	(0.6)	(1.2)
Total	$ 78.9	$ 13.2	$ 92.1	$ 24.4	$120.8	$145.2
Interest- Bearing Liabilities:						
Total deposits	$ 76.4	$ 1.8	$ 78.2	$ 54.5	$ 31.0	$ 85.5
FHLB advances	23.5	(18.2)	5.3	(5.5)	44.0	38.5
Security repurchase agreements	8.8	35.6	44.4		7.9	7.9
Other	1.7	(6.2)	(4.5)	(5.1)	(4.6)	(9.7)
Total	$110.4	$ 13.0	$123.4	$ 43.9	$ 78.3	$122.2
Change in net interest income	$ (31.5)	$ 0.2	$ (31.3)	$(19.5)	$ 42.5	$ 23.0

The rate/volume table above indicates that, in general, interest rates on deposits and other liabilities increased to a greater extent than interest rates on our loan products and securities during the year ended December 31, 2006. The adverse impact of these rate changes on our net interest margin for the periods were offset in part by the effect of the increase in interest-earning assets over interest-bearing liabilities.

Our interest income on loans increased as a result of increased yields on new loan production. This increase offset the decline in interest income attributable to a reduced volume of loans, which declined as certain loans were pooled and exchanged for mortgage-backed securities that we hold on our balance sheet as an investment. Similarly, the increase in interest income arising from mortgage-backed securities held-to-maturity related principally to the increase in the volume of such securities created using our investment loans.

During 2006, the decrease in net interest income was primarily due to the 28 basis point decrease in net interest margin, partially offset by the effect of the increase in interest earning assets over interest-bearing liabilities. Net interest margin continued to experience compression due to the lag in the repricing of the Bank s loan portfolio compared to the increase in the cost of its interest-bearing liabilities.

During 2005, the increase in the net interest income was primarily due to the increase in the interest earnings assets of $2.4 billion, partially offset by the 17 basis point decrease in net interest margin. Net interest margin experienced compression because the increase in interest rates on our liabilities increased much more than the rates on our loan production.

Provision for Loan Losses

During 2006, we recorded a provision for loan losses of $25.4 million as compared to $18.9 million recorded during 2005 and $16.1 million recorded in 2004. The provisions reflect our estimates to maintain the allowance for loan losses at a level to cover probable losses in the portfolio for each of the respective periods.

The increase in the provision during 2006 as compared to 2005, which increased the allowance for loan losses to $45.8 million at December 31, 2006 from $39.1 million at December 31, 2005, reflects the increase in net charge-offs both as a dollar amount and as a percentage of the loans held for investment, and also the increase in overall loan delinquencies (i.e., loans at least 30 days past due) in 2006. Net charge-offs in 2006 totaled $18.8 million as compared to $18.1 million in 2005, reflecting increased charge-offs of home equity and second mortgage loans and of overdrafts from checking accounts. As a percentage of the average loans held for investment, net charge-offs in 2006 increased to 0.20% from 0.16% in 2005. At the same time, overall loan delinquencies increased to 1.34% of total loans held for investment at December 31, 2006 from 1.10% at December 31, 2005, Total delinquent loans increased to $119.3 million in 2006 as compared to $115.9 million in 2005. The increase in delinquencies related primarily to residential mortgage loans, increasing to 1.59% at December 31, 2006 from 1.16% at December 31, 2005, as well as slight increases in delinquencies of home equity and second mortgage loans.

The increase in the provision during 2005 to $18.9 million from $16.1 million during 2004 increased the allowance for loan losses to $39.1 million at December 31, 2005 as compared to $38.3 million at December 31. 2004. The 2005 provision principally reflects net charge-offs of $18.1 million during the year, as compared to $15.6 million during 2004. Overall loan delinquencies (i.e., loans at least 30 days past due) also increased at December 31, 2005 to $115.9 million, or 1.10% of total loans held for investment, from $104.0 million, or 0.99%, at December 31, 2004, with 2005 delinquencies increasing principally in residential mortgage loans, to 1.16%, or $95.7 million at December 31, 2005 from 1.02%, or $88.5 million at December 31, 2004, and commercial real estate loans.

See the section captioned Allowance for Loan Losses in this discussion for further analysis of the provision for loan losses.

Non-Interest Income

Our non-interest income consists of (i) loan fees and charges, (ii) deposit fees and charges, (iii) loan administration fees, (iv) net gains from loan sales, (v) net gains from sales of MSRs, (vi) net loss on securities available for sale and (vii) other fees and charges. Our total non-interest income equaled $202.2 million during 2006, which was a 26.8% increase from the $159.4 million of non-interest income that we earned in 2005. The primary reason for the increase was the increase in 2006 of net gains from sales of MSRs.

Loan Fees and Charges. Both our home lending operation and banking operation earn loan origination fees and collect other charges in connection with originating residential mortgages and other types of loans. In each period, we recorded fee income net of any fees deferred for the purposes of complying with SFAS 91, *Accounting for Non-Refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* During 2006, we recorded gross loan fees and charges of $50.9 million, a decrease of $20.7 million from the $71.6 million recorded in 2005 and the $83.0 million recorded in 2004. The decline in loan fees and charges resulted from a reduction in the volume of loans originated during 2006 compared to 2005 and 2004. To a large degree, the decrease in loan originations during 2006 was attributable to a continuing decline in mortgage refinancings in the overall market as a result of stabilizing or increasing interest rates on single-family mortgage loans.

In accordance with SFAS 91, loan origination fees are capitalized and added as an adjustment to the basis of the individual loans originated. These fees are accreted into income as an adjustment to the loan yield over the life of the loan or when the loan is sold. During 2006, we deferred $43.4 million of fee revenue in accordance with SFAS 91, compared to $59.0 million and $65.0 million, respectively, in 2005 and 2004.

Deposit Fees and Charges. Our banking operation collects deposit fees and other charges such as fees for non-sufficient funds checks, cashier check fees, ATM fees, overdraft protection, and other account fees for services we provide to our banking customers. The amount of these fees tends to increase as a function of the growth in our deposit base. Total deposit fees and charges increased 23.7% during 2006 to $20.9 million compared to $16.9 million during 2005 and $12.1 million during 2004. During that time, total customer accounts grew from 196,000 at January 1, 2004 to over 277,900 at December 31, 2006.

Loan Administration Fees. When our home lending operation sells mortgage loans in the secondary market, it usually retains the right to continue to service these loans and earn a servicing fee. When an underlying loan is prepaid or refinanced, the mortgage servicing right for that loan is fully amortized as no further fees will be earned for servicing that loan. During periods of falling interest rates, prepayments and refinancings generally increase and, unless we provide replacement loans, it will usually result in a reduction in loan servicing fees and increases in amortization recorded on the MSR portfolio.

Our loan administration fees and MSR amortization can fluctuate significantly. Such fees are affected by the size of our loans serviced for others portfolio, which is affected by sales of MSRs, subservicing fees, late fees and ancillary income and past due status of serviced loans. When loans serviced for others become ninety days or more past due we cease accruing servicing fees on such loans. Amortization of MSRs can be affected by sales of MSRs and changes in interest rates that cause changes in prepayments of the underlying loans. Changes in loan administration fees and changes in amortization of MSRs will not necessarily occur in proportion.

During 2006, the volume of loans serviced for others averaged $20.3 billion, which represented a 24.3% decrease from the $26.8 billion serviced during 2005. During 2006, we recorded $82.6 million in servicing fee revenue. The fee revenue recorded in 2006 was offset by $69.6 million of MSR amortization. During 2006, the amount of loan principal payments and payoffs received on serviced loans equaled $3.1 billion, a 26.2% decrease over the 2005 total of $4.2 billion. The decrease was primarily attributable to the continuing increase in interest rates and the related decline in mortgage loan refinancing in 2006.

During 2005, the volume of loans serviced for others averaged $26.8 billion, which represented a 1.5% increase from the $26.4 billion during 2004. During 2005, we recorded $103.3 million in servicing fee revenue. The fee revenue recorded in 2005 was offset by $94.5 million of MSR amortization. During 2005, the amount of loan principal payments and payoffs received on serviced loans equaled $4.2 billion, a 40.0% decrease over the 2004 total of $7.0 billion. The decrease was primarily attributable to the continuing increase in interest rates and the related decline in mortgage loan refinancing in 2005.

Net Gain on Loan Sales. Our home lending operation records the transaction fee income it generates from the origination, securitization and sale of mortgage loans in the secondary market. The amount of net gain on loan sales recognized is a function of the volume of mortgage loans sold and the gain on sale spread achieved, net of related selling expenses. Net gain on loan sales is also increased or decreased by any mark to market pricing adjustments on loan commitments and forward sales commitments in accordance with SFAS No. 133, *Accounting for Derivative Instruments* (SFAS 133), increases to the secondary market reserve related to loans sold during the period, and related administrative expenses. The volatility in the gain on sale spread is attributable to market pricing, which changes with demand and the general level of interest rates. Generally, we are able to sell loans into the secondary market at a higher margin during periods of low or decreasing interest rates. Typically, as the volume of acquirable loans increases in a lower or falling interest rate environment, we are able to pay less to acquire loans and are then able to achieve higher spreads on the eventual sale of the acquired loans. In contrast, when interest rates rise, the volume of acquirable loans decreases and therefore we may need to pay more in the acquisition phase, thus decreasing our net gain achievable. Our net gain was also affected by declining spreads available from securities we sell that are guaranteed by Fannie Mae and Freddie Mac, and by an over-capacity in the mortgage business that has placed continuing downward pressure on loan pricing opportunities for conventional residential mortgage products.

The following table indicates the net gain on loan sales reported in our consolidated financial statements to our loans sold and securitized within the period (dollars in thousands):

	For the Years Ended December 31,		
	2006	**2005**	**2004**
Net gain on loan sales	$ 42,381	$ 63,580	$ 77,819
Loans sold and securitized	$16,370,925	$23,451,430	$28,937,576
Spread achieved	0.26%	0.27%	0.27%

2006. Net gain on loan sales totaled $42.4 million during 2006, a 33.3% decrease from the $63.6 million realized during 2005. During 2006, the volume of loans sold and securitized totaled $16.4 billion, a 30.2% decrease from the $23.5 billion of loan sales in 2005. Our calculation of net gain on loan sales reflects changes in amounts related to SFAS 133, lower of cost or market adjustments on loans transferred to held for investment and provisions to our secondary market reserve. Changes in amounts related to SFAS 133 amounted to $(4.4) million and $2.9 million for the years ended December 31, 2006 and 2005, respectively. Lower of costs or market adjustments on loans transferred to held for investment amounted to $2.0 million and $87,000 for the years ended December 31, 2006 and 2005, respectively. Provisions to our secondary market reserve amounted to $5.9 million and $5.3 million, for the years ended December 31, 2006 and 2005, respectively. Also included in our net gain on loan sales are the capitalized value of our MSR s, which totaled $223.9 million and $329.0 million for the years ended December 31, 2006 and 2005, respectively.

2005. Net gains on loan sales totaled $63.6 million during 2005, an 18.3% decrease from the $77.8 million realized during 2004. During 2005, the volume of loans sold and securitized totaled $23.5 billion, an 18.7% decrease from the $28.9 billion of loan sales in 2004. Our calculation of net gain on loan sales reflects changes in SFAS 133, lower of cost or market adjustments and provisions to our secondary market reserve. Changes in amounts related to SFAS 133 amounted to $2.9 million and $357,000 for the years ended December 31, 2005 and 2004, respectively. Lower of costs or market adjustments on loans transferred to held for investment amounted to $87,000 and $0 for the years ended December 31, 2005 and 2004, respectively. Provisions to our secondary market reserve amounted to $5.3 million and $5.9 million, for the years ended December 31, 2005 and 2004, respectively. Also included in our net gain on loan sales are the capitalized value of our MSR s, which totaled $329.0 million and $318.0 million for the years ended December 31, 2005 and 2004, respectively.

Net Gain on Mortgage Servicing Rights Sales. As part of our business model, our home lending operation occasionally sells MSRs in transactions separate from the sale of the underlying loans. At the time of the MSR sale, we record a gain or loss based on the selling price of the MSRs less our carrying value and transaction costs. Accordingly, the amount of net gains on MSR sales depends upon the gain on sale spread and the volume of MSRs sold. The spread is attributable to market pricing, which changes with demand, and the general level of interest rates. In general, if an MSR is sold on a flow basis shortly after it is acquired, little or no gain will be realized on the sale. MSRs created in a lower interest rate environment generally will have a higher market value because the underlying loan is less likely to be prepaid. Conversely, an MSR created in a higher interest rate environment will generally sell at a market price below the original fair value recorded because of the increased likelihood of prepayment of the underlying loans, resulting in a loss.

2006. During 2006, the net gain on the sale of MSRs totaled $92.6 million compared to a net gain of $18.2 million in 2005. The $74.4 million increase in net gain on the sale of MSRs is primarily due to a significant increase in the volume of MSRs sold in 2006. Throughout 2006, we believed that the current market price accurately reflected the MSR value. As a result, we sold more MSRs in 2006 than prior periods. We sold $2.3 billion in loans on a servicing released basis and $25.2 billion in bulk servicing sales in 2006.

2005. During 2005, the net gain on the sale of MSRs totaled only $18.2 million compared to a net gain of $91.7 million in 2004. The $73.5 million decrease in net gain on the sale of MSRs is primarily due to a significant reduction in the volume of MSRs as sold in 2005. Throughout most of 2005, we believed that the current market for these MSRs did not fully reflect their value. Accordingly, we retained more MSRs in 2005 than in prior periods. We sold $1.9 billion of MSRs on a servicing released basis and $7.2 billion in bulk servicing sales in 2005.

Net Loss on Securities Available for Sale. Securities classified as available for sale are comprised of residual interests from private securitizations and mortgage-backed and collateralized mortgage obligation securities. Net loss on securities available for sale is the result of a reduction in the estimated fair value of the security when that decline has been deemed to be an other-than-temporary impairment.

The $6.1 million in impairment charges on our residual interest in 2006 resulted from changes in the interest rate environment, benchmarking procedures applied against updated industry data and third party valuation data that resulted in adjusting the critical prepayment speed assumption utilized in valuing such security. Specifically, we completed a private-label securitization of home equity lines of credit in the fourth quarter of 2005. In determining the appropriate assumptions to model the transaction, we utilized our recent history of similar products, available industry information and advice from third party consultants experienced in securitizations. At the same time, we had observed prepayment speeds in the 30%-35% constant prepayment rate (CPR) range for our portfolio, which was consistent with the available industry data. After consulting with our advisors, we utilized a 40% CPR assumption in our modeling in order to reflect our belief that there would be only a modest increase in the prepayment speeds in the near term due to our expectations of interest rate movements and the possibility of an inverted yield curve. As short-term interest rates increased throughout the fourth quarter of 2005 and the first quarter of 2006 and the yield curve flattened, the prepayment speed of the portfolio increased at a much higher rate than anticipated. We attributed this to fixed rate loans that became available at lower rates than the adjustable-rate HELOC loans in the securitization pool. We also noted that this increased prepayment speed with HELOCs was occurring industry-wide. The appropriateness of adjusting the model s prepayment speed upward was validated by both a third party valuation firm and our own backtesting procedures. Based on this information, we adjusted our cash flow model to incorporate our updated prepayment speed during the first quarter of 2006. As a result, at March 31, 2006, a significant deterioration of the residual asset was determined to have occurred. We further analyzed the result and determined that approximately $3.5 million of the deterioration was other than temporary. An additional amount of the deterioration was deemed to be temporary and recorded as a portion of other comprehensive income. This was based on our belief, following further discussions with our advisors, that prepayment speeds would moderate during the year as the portfolio seasoned. However, as the yield curve continued to flatten and even invert during the third and fourth quarters of 2006, prepayment speeds not only failed to moderate, but actually accelerated. Additionally, based on our analysis, we did not believe that the inverted yield curve would only be a short-term phenomenon. Based on these factors and our cash flow models, we determined that additional other than temporary impairment had taken place. Such amounts were recorded as identified and resulted in the $6.1 million in impairment charges for 2006.

Other Fees and Charges. Other fees and charges include certain miscellaneous fees, including dividends received on FHLB stock and income generated by our subsidiaries Flagstar Credit Corporation and Douglas Insurance Agency, Inc. Flagstar Title Insurance Company also earned fees in 2004 prior to its closing.

During 2006, we recorded $14.7 million in dividends on an average outstanding balance of FHLB stock of $284.2 million as compared to $11.1 million and $9.9 million in dividends on an average balance of FHLB stock outstanding of $264.2 million and $225.1 million in 2005 and 2004, respectively. During 2006, Flagstar Credit earned fees of $4.8 million versus $4.9 million and $5.0 million in 2005 and 2004, respectively. The amount of fees earned by Flagstar Credit varies with the volume of loans that were insured during the respective periods. Flagstar Title reported revenues of $108,000 in 2004.

Non-Interest Expense

The following table sets forth detailed information regarding our non-interest expenses during the past three years.

NON-INTEREST EXPENSES

	For the Years Ended December 31,		
	2006	**2005**	**2004**
		(In thousands)	
Compensation and benefits	$157,751	$ 150,738	$ 154,111
Commissions	74,208	87,746	105,607
Occupancy and equipment	70,319	69,121	66,233
Advertising	9,394	7,550	10,174
FDIC assessments	1,115	1,146	1,050
Communication	6,190	7,181	6,975
Other taxes	320	10,127	12,999
Other	49,824	46,362	39,926
Total	369,121	379,971	397,075
Less: capitalized direct costs of loan closings, in accordance with SFAS 91	(93,484)	(117,084)	(154,070)
Total, net	$275,637	$ 262,887	$ 243,005
Efficiency ratio(1)	66.1%	64.8%	50.7%

(1) Total operating and administrative expenses divided by the sum of net interest income and non-interest income.

2006. Non-interest expenses, before the capitalization of direct costs of loan closings, totaled $369.1 million in 2006 compared to $380.0 million in 2005. The 2.9% decrease in non-interest expense in 2006 was largely due to lower commissions resulting from a decrease in the volume of loan originations in our home lending operations and from our general cost containment efforts. Offsetting the savings in our home lending operation were certain expenses associated with the increase in the number of banking centers operated by our banking operation. During 2006, we opened 14 banking centers, which brings the banking center network total to 151. As we shift our funding sources to more of those that are retail in nature and increase the size of the banking center network, we expect that the operating expenses associated with the banking center network will continue to increase.

Our gross compensation and benefit expense, before the capitalization of direct costs of loan closings, totaled $157.8 million. The 4.7% increase from 2005 is primarily attributable to normal salary increases and the employees hired at the new banking centers. Our full-time equivalent (FTE) salaried employees increased by 105 to 2,510 at December 31, 2006. Commission expense, which is a variable cost associated with loan production, totaled $74.2 million, equal to 37 basis points (0.37 %) of total loan production in 2006. Occupancy and equipment totaled $70.3 million during 2006, which reflects the continuing expansion of our deposit banking center network, offset in part by the closing of various non- profitable home loan centers. Advertising expense, which totaled $9.4 million at December 31, 2006, increased $1.8 million, or 24.4%, from the $7.6 million reported in 2005. Our FDIC assessment remained the same at $1.1 million as compared to 2005. We paid $6.2 million in communication expense for the year-ended December 31, 2006. These expenses typically include telephone, fax and other types of electronic communication. The decrease in communication expenses is reflective of fewer home loan centers. We pay taxes in the various states and local communities in which we are located and/or do business. For the year ended December 31, 2006 our state and local taxes totaled $0.3 million, a decrease of $9.8 million, which is the result of a restructuring of our corporate operations that better aligned our core functions in separate entities. Other expense totaled $49.8 million during 2006. The fluctuation in other expenses is reflective of the varied levels of loan production, the expansion undertaken in our banking operation offset by the closing of the non-profitable home loan centers and the dismissal of our lawsuit against an insurance company in a coverage dispute that resulted in a charge in November 2006, of $8.7 million, before taxes.

2005. Non-interest expenses, before the capitalization of direct costs of loan closings, totaled $380.0 million in 2005 compared to $397.1 million in 2004. The 4.3% decrease in non-interest expense in 2005 was due to lower compensation expense and lower commissions resulting from a decrease in the volume of loan originations in our home lending operations and from our general cost containment efforts. Offsetting the savings in our home lending operation were certain expenses associated with the increase in the number of banking centers operated by our banking operation. During 2005, we opened 17 banking centers, which brought the banking center network total to 137. As we shift our funding sources to more those retail in nature and increase the size of the banking center network, we expect that the operating expenses associated with the banking center network will continue to increase.

Our gross compensation and benefit expense, before the capitalization of direct costs of loan closings, totaled $150.7 million. The 2.2% decrease from 2004 is primarily attributable to the staff reductions due to the decrease in loan production offset with normal salary increases and the employees hired at the new banking centers. Our full-time equivalent (FTE) employees only increased by nine to 2,405 at December 31, 2005. Commission expense, which is a variable cost associated with loan production, totaled $87.7 million, equal to 29 basis points (0.29%) of total loan production in 2005. Occupancy and equipment totaled $69.1 million during 2005, which reflects the continuing expansion of our deposit banking center network, offset in part by the closing of various non- profitable home loan centers. Advertising expense, which totaled $7.6 million at December 31, 2005, decreased $2.5 million, or 25.7%, from the $10.1 million reported in 2004. Our FDIC assessment remained the same at $1.1 million as compared to 2004. The calculation of the premiums is based on our deposit portfolio and escrow accounts. We paid $7.2 million in communication expense for the year-ended December 31, 2005. These expenses typically include telephone, fax and other types of electronic communication. The slight increase in communication expenses is reflective of additional branch locations. We pay taxes in the various states and local communities in which we are located and do business. For the year ended December 31, 2005 our state and local taxes totaled $10.1 million, a decrease of $1.9 million, which is the result of a decrease in taxable earnings. Other expense totaled $46.4 million during 2005. The fluctuation in the expenses is reflective of the varied levels of loan production, the expansion undertaken in our banking operation offset by the closing of the non-profitable home loan centers.

SFAS 91

Loan origination fees and costs are capitalized and recorded as an adjustment to the basis of the individual loans originated. These fees and costs are amortized or accreted into income as an adjustment to the loan yield over the life of the loan or expensed when the loan is sold. Accordingly, during 2006, we deferred $93.5 million of gross loan origination costs, while during 2005 and 2004 the deferred expenses totaled $117.1 million and $154.1 million, respectively. These costs have not been offset by the revenue deferred for SFAS 91 purposes. During the year to date in 2006 and the years 2005, and 2004, we deferred $43.4 million, $59.0 million, and $65.0 million in qualifying loan fee revenue, respectively. For further information, see Loan Fees and Charges, above.

On a per loan basis, the cost deferrals totaled $992, $816, and $815 during 2006, 2005, and 2004, respectively. Net of deferred fee income, the cost deferred per loan totaled $531, $405, and $471 for years 2006, 2005, and 2004, respectively. While revenue per loan has remained somewhat constant on a per loan basis, our loan origination costs have increased over the three-year period. Inflationary increases and the increased costs associated with our shift to retail and correspondent funding versus wholesale funding are the major reasons for these increases. This shift can also be seen in the cost of commissions, which is a deferrable item. On a per loan basis, the cost deferrals for commissions totaled $788, $566, and $559 during 2006, 2005, and 2004, respectively.

Provision for Federal Income Taxes

For the year ended December 31, 2006, our provision for federal income taxes as a percentage of pretax earnings was 35.2% compared to 35.6% in 2005 and 35.2% in 2004. For each period, the provision for federal income taxes varies from statutory rates primarily because of certain non-deductible corporate expenses. Refer to Note 18 of the Notes to the Consolidated Financial Statements, in Item 8. Financial Statements and Supplementary Data herein for further discussion of our federal income taxes.

Analysis of Items on Statement of Financial Condition

Mortgage-Backed Securities Held to Maturity. Mortgage-backed securities held to maturity increased from $1.4 billion at December 31, 2005 to $1.6 billion at December 31, 2006. The increase was due to the recharacterization of certain mortgage loans held for investment to mortgage-backed securities through guaranteed mortgage securitizations. This allowed us to obtain credit enhancement on these loans and thereby reduce our credit risk. During 2006, we converted $558.7 million of mortgage loans in our portfolio to mortgage-backed securities through a combination or government sponsored entities and the completion of a private securitization.

At December 31 2006 and 2005, approximately $1.0 billion and $1.2 billion, respectively, of these mortgage-backed securities were pledged as collateral under security repurchase agreements. This allowed us to obtain funds at a lower cost than our FHLB advances. In addition, at December 31, 2005, $2.9 million of the mortgage-backed securities were pledged as collateral for interest rate swap agreements.

Securities Available for Sale. Securities available for sale, which are comprised of mortgage-backed securities, collateralized mortgage obligations and residual interests from securitizations of mortgage loan products increased from $26.1 million at December 31, 2005, to $617.5 million at December 31, 2006. The increase was due to the purchase of $574.9 million in mortgage-backed and collateralized mortgage obligation securities and completion of two additional private securitizations during the year of fixed second mortgage loans and home equity revolving lines of credit loans, that resulted in residual interests of $21.7 million, offset by a $6.1 million reduction in fair value of the residual interest related to our December 2005 securitization.

Other Investments. Our investment portfolio increased from $22.0 million at December 31, 2005 to $24.0 million at December 31, 2006. Investment securities consist of contractually required collateral, regulatory required collateral, and investments made by our non-bank subsidiaries.

Loans Available for Sale. We sell a majority of the mortgage loans we produce into the secondary market on a whole loan basis or by securitizing the loans into mortgage-backed securities. We generally sell or securitize our longer-term, fixed-rate mortgage loans, while we hold the shorter duration and adjustable rate mortgage loans for investment. At December 31, 2006, we held loans available for sale of $3.2 billion, which was an increase of $1.4 billion from $1.8 billion held at December 31, 2005. Our loan production is typically inversely related to the level of long-term interest rates. As long-term rates decrease, we tend to originate an increasing number of mortgage loans. A significant amount of the loan origination activity during periods of falling interest rates is derived from refinancing of existing mortgage loans. Conversely, during periods of increasing long-term rates increase, loan originations tend to decrease.

The following table shows the activity in our portfolio of loans available for sale during the past five years:

LOANS AVAILABLE FOR SALE ACTIVITY SCHEDULE

	For the Years Ended December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
			(In thousands)		
Balance, beginning of year	$ 1,773,394	$ 1,506,311	$ 2,759,551	$ 3,302,212	$ 2,746,791
Loans originated, net	18,057,340	25,202,205	31,943,915	55,866,218	43,703,804
Loans sold servicing retained, net	(13,974,425)	(21,608,937)	(27,749,138)	(49,681,387)	(39,261,704)
Loans sold servicing released, net	(2,395,466)	(1,855,700)	(1,352,789)	(2,461,326)	(1,297,372)
Loan amortization/ prepayments	(1,246,419)	(1,040,315)	(1,798,137)	(1,652,811)	(461,983)
Loans transferred from (to) various loan portfolios, net	974,370	(430,170)	(2,297,091)	(2,613,355)	(2,127,324)
Balance, end of year	$ 3,188,795	$ 1,773,394	$ 1,506,311	$ 2,759,551	$ 3,302,212

Loans Held for Investment. Our largest category of earning assets consists of our loans held for investment portfolio. Loans held for investment consists of residential mortgage loans that we do not hold for resale (usually shorter duration and adjustable rate loans and second mortgages), other consumer loans, commercial real estate loans, construction loans, warehouse loans to other mortgage lenders, and various types of commercial loans such as business lines of credit, working capital loans and equipment loans. Loans held for investment decreased from $10.6 billion in December 2005, to $8.9 billion in December 2006. Mortgage loans held for investment decreased $2.0 billion to $6.2 billion, second mortgage loans increased $14.7 million to $715.2 million, commercial real estate loans increased $0.3 billion to $1.3 billion and consumer loans decreased $70.7 million to $340.2 million. The following table sets forth a breakdown of our loans held for investment portfolio at December 31, 2006:

LOANS HELD FOR INVESTMENT, BY RATE

	Fixed Rate	**Adjustable Rate**	**Rate Total**
		(In thousands)	
Mortgage loans	$ 713,529	$ 5,498,236	$ 6,211,765
Second mortgage loans	594,237	120,917	715,154
Commercial real estate loans	616,012	685,807	1,301,819