FREMONT GENERAL CORP
Form 10-Q
November 09, 2007

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United States Securities and Exchange Commission
Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Quarterly Period Ended September 30, 2007

OR

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Transition Period from to

Commission File Number 001-08007

Fremont General Corporation
(Exact Name of Registrant as Specified in its Charter)

Nevada (State or other jurisdiction of incorporation or organization)	**95-2815260** (I.R.S. Employer Identification No.)
2425 Olympic Boulevard **Santa Monica, California 90404** (Address of principal executive offices) (Zip Code)	**(310) 315-5500** (Registrant s Telephone Number, Including Area Code)

Not Applicable
(Former Name or Former Address, if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required 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. þ Yes o No

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

þ Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock:

Class	Shares Outstanding October 31, 2007
Common Stock, $1.00 par value	79,630,085

Fremont General Corporation and Subsidiaries

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Item 1. *Financial Statements*

Fremont General Corporation and Subsidiaries
Consolidated Balance Sheets

(Thousands of dollars, except share data)		September 30, 2007		December 31, 2006
		(Unaudited)		
ASSETS				
Cash and cash equivalents	**$**	**2,658,068**	$	761,642
Investment securities classified as available-for-sale at fair value		**1,175,858**		633
Federal Home Loan Bank stock at cost		**25,925**		111,860
Loans held for investment net		**2,116**		6,257,306
Commercial real estate participation		**3,624,260**		
Accrued interest receivable		**32,231**		53,497
Real estate owned net				299
Premises and equipment net		**24,647**		67,859
Deferred income taxes net				52,576
Other assets		**341,137**		268,932
Assets of discontinued operations held for sale		**906,825**		5,315,920
TOTAL ASSETS	**$**	**8,791,067**	$	12,890,524
LIABILITIES				
Deposits:				
Savings accounts	**$**	**954,686**	$	1,101,137
Money market deposit accounts		**419,815**		586,158
Certificates of deposit		**6,586,025**		8,302,493
		7,960,526		9,989,788
Senior Notes due 2009		**166,111**		165,895
Junior Subordinated Debentures		**103,093**		103,093
Other liabilities		**141,929**		210,586
Liabilities of discontinued operations held for sale		**114,450**		1,307,205
TOTAL LIABILITIES		**8,486,109**		11,776,567
Commitments and contingencies				
STOCKHOLDERS EQUITY				
Preferred stock, par value $.01 per share Authorized: 2,000,000 shares; none issued				
		78,117		75,983

Common stock, par value $1 per share Authorized: 150,000,000 shares; issued and outstanding: (2007 79,630,000 and 2006 79,074,000)		
Additional paid-in capital	**344,535**	324,064
Retained earnings	**(112,023)**	728,766
Deferred compensation	**(8,005)**	(20,694)
Accumulated other comprehensive income	**2,334**	5,838
TOTAL STOCKHOLDERS EQUITY	**304,958**	1,113,957
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	**$ 8,791,067**	$ 12,890,524

The accompanying notes are an integral part of these statements.

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Fremont General Corporation and Subsidiaries
Consolidated Statements of Operations (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Thousands of dollars, except per share data)	2007	2006	2007	2006
INTEREST INCOME:				
Interest and fee income on loans:				
Commercial	**$ 1,444**	$ 144,305	**$ 292,688**	$ 380,365
Other	**129**		**321**	1
	1,573	144,305	**293,009**	380,366
Interest income other	**128,601**	8,883	**169,133**	22,837
	130,174	153,188	**462,142**	403,203
INTEREST EXPENSE:				
Deposits	**99,442**	56,747	**277,448**	140,401
Senior Notes	**3,351**	3,388	**10,051**	10,398
Junior Subordinated Debentures	**2,319**	2,320	**6,958**	6,959
	105,112	62,455	**294,457**	157,758
Net interest income	**25,062**	90,733	**167,685**	245,445
Provision for loan losses	**151**	12,687	**333**	28,288
Net interest income after provision for loan losses	**24,911**	78,046	**167,352**	217,157
NON-INTEREST INCOME:				
Gain on sale of commercial real estate loans	**16,289**		**16,289**	
Other non-interest income	**49,600**	4,825	**51,056**	11,129
	65,889	4,825	**67,345**	11,129
NON-INTEREST EXPENSE:				
Compensation and related	**14,356**	25,134	**88,813**	77,535
Occupancy	**3,060**	3,279	**12,945**	10,128
Other	**19,450**	19,591	**76,141**	49,116
	36,866	48,004	**177,899**	136,779
INCOME BEFORE INCOME TAXES	**53,934**	34,867	**56,798**	91,507
Income tax expense	**21,738**	12,190	**24,518**	34,797

Income from continuing operations		**32,196**		22,677		**32,280**		56,710
Income (loss) from discontinued operations, net of income taxes of $(9,480) and $4,986, and $(92,356) and $38,101 for the three and nine months ended September 30, 2007 and 2006, respectively		**(13,895)**		6,848		**(869,773)**		56,426
Net income (loss)	**$**	**18,301**	$	29,525	**$**	**(837,493)**	$	113,136
EARNINGS PER SHARE:								
Basic:								
Income from continuing operations	**$**	**0.42**	$	0.31	**$**	**0.42**	$	0.77
Income (loss) from discontinued operations, net of income taxes		**(0.18)**		0.09		**(11.39)**		0.76
Net income (loss)	**$**	**0.24**	$	0.40	**$**	**(10.97)**	$	1.53
Diluted:								
Income from continuing operations	**$**	**0.41**	$	0.30	**$**	**0.42**	$	0.75
Income (loss) from discontinued operations, net of income taxes		**(0.18)**		0.09		**(11.25)**		0.74
Net income (loss)	**$**	**0.23**	$	0.39	**$**	**(10.83)**	$	1.49
CASH DIVIDENDS DECLARED PER COMMON SHARE	**$**		$	0.11	**$**		$	0.33

The accompanying notes are an integral part of these statements.

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Fremont General Corporation and Subsidiaries
Consolidated Statements of Changes in Stockholders Equity (Unaudited)

	Common Stock					Accumulated	
housands, except per share amounts)	Number of Outstanding Shares	Amount	Additional Paid-in Capital	Retained Earnings	Deferred Compensation	Other Comprehensive Income	To
nce at December 31, 2005	77,497	$ 77,497	$ 341,800	$ 966,112	$ (43,357)	$ 14,754	$ 1,356,8
income				113,136			113,1
n dividends declared $0.33 per share				(25,621)			(25,6
assification of deferred compensation estricted stock		(1,485)	(19,417)		20,902		
rement of common stock	(41)						
es issued, acquired or allocated for loyee benefit plans	406		(1,673)		(23,036)		(24,7
ortization of restricted stock			11,074				11,0
es allocated to ESOP			(1,370)		24,315		22,9
nge in cost of common stock held in					(1,718)		(1,7
change in unrealized gain on stments and residual interests, net of rred taxes						2,405	2,4
ess tax benefits relating to share-based nents			2,050				2,0
OP fair value adjustment			(755)		755		
nce at September 30, 2006	77,862	$ 76,012	$ 331,709	$ 1,053,627	$ (22,139)	$ 17,159	$ 1,456,3
nce at December 31, 2006	79,074	$ 75,983	$ 324,064	$ 728,766	$ (20,694)	$ 5,838	$ 1,113,9
loss				(837,493)			(837,4
n dividends adjustment				93			
ption of FIN No. 48				(3,389)			(3,3
rement of common stock	(1,088)						
ricted stock vested		849	13,937				14,7
es issued, acquired or allocated for loyee benefit plans	359		(2,920)		(5,187)		(8,1
ortization of restricted stock			4,361				4,3
es allocated to ESOP	1,285	1,285	8,249		3,334		12,8
nge in cost of common stock held in					11,386		11,3
change in unrealized gain on stments and residual interests, net of rred taxes						(3,504)	(3,5
OP fair value adjustment			(3,156)		3,156		

nce at September 30, 2007	**79,630**	**$**	**78,117**	**$**	**344,535**	**$**	**(112,023)**	**$**	**(8,005)**	**$**	**2,334**	**$**	**304,9**

The accompanying notes are an integral part of these statements.

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Fremont General Corporation and Subsidiaries
Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended September 30,	
(Thousands of dollars)	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	**$ (837,493)**	$ 113,136
Less: income (loss) from discontinued operations	**(869,773)**	56,426
Income from continuing operations	**32,280**	56,710
Adjustments to reconcile income from continuing operations to net cash provided by operating activities:		
Provision for loan losses	**333**	28,288
Provision for deferred income taxes	**14,267**	6,669
Depreciation and amortization	**16,227**	11,898
Compensation expense related to deferred compensation plans	**273**	4,872
Change in accrued interest	**34,720**	(28,711)
Change in other assets	**(226,924)**	(34,043)
Change in accounts payable and other liabilities	**(110,375)**	(31,392)
Originations and advances funded for commercial real estate loans held for sale	**(1,664,535)**	
Payments received from and sales of commercial real estate loans held for sale	**3,731,306**	
NET CASH PROVIDED BY OPERATING ACTIVITIES CONTINUING OPERATIONS	**1,827,572**	14,291
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES DISCONTINUED OPERATIONS	**3,626,653**	(114,595)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	**5,454,225**	(100,304)
CASH FLOWS FROM INVESTING ACTIVITIES		
Originations of loans held for investment		(3,068,122)
Payments received from and sales of loans held for investment		1,711,609
Investment securities available for sale:		
Purchases	**(1,307,516)**	(4,352)
Maturities or repayments	**132,187**	210
Net purchases of FHLB stock	**85,935**	(12,972)
Payments received from commercial real estate participation	**576,948**	
Purchases of premises and equipment	**(5,126)**	(16,064)
NET CASH USED IN INVESTING ACTIVITIES CONTINUING OPERATIONS	**(517,572)**	(1,389,691)
	72,634	75,987

NET CASH PROVIDED BY INVESTING ACTIVITIES DISCONTINUED OPERATIONS		
NET CASH USED IN INVESTING ACTIVITIES	**(444,938)**	(1,313,704)
CASH FLOWS FROM FINANCING ACTIVITIES		
Deposits accepted, net of repayments	**(2,029,262)**	957,499
Extinguishment of Senior Notes		(9,636)
Dividends paid	**(9,489)**	(24,806)
Excess tax benefits related to share-based payments		2,050
Purchase of Company common stock for deferred compensation plans	**(14,110)**	(40,601)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES CONTINUING OPERATIONS	**(2,052,861)**	884,506
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES DISCONTINUED OPERATIONS	**(1,060,000)**	281,000
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	**(3,112,861)**	1,165,506
Increase (decrease) in cash and cash equivalents	**1,896,426**	(248,502)
Cash and cash equivalents at beginning of period	**761,642**	768,643
Cash and cash equivalents at end of period	**$ 2,658,068**	$ 520,141

The accompanying notes are an integral part of these statements.

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Fremont General Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

(Thousands of dollars)	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Net income (loss)	**$ 18,301**	$ 29,525	**$ (837,493)**	$ 113,136
Other comprehensive income (loss):				
Net change in unrealized gains (losses) during the period:				
Residual interests in securitized loans	**(1,999)**	(4,023)	**(8,408)**	2,010
Investment securities	**2,608**	(149)	**2,607**	1,909
	609	(4,172)	**(5,801)**	3,919
Less income tax expense (benefit)	**246**	(1,656)	**(2,297)**	1,514
Other comprehensive income (loss)	**363**	(2,516)	**(3,504)**	2,405
Total comprehensive income (loss)	**$ 18,664**	$ 27,009	**$ (840,997)**	$ 115,541

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Fremont General Corporation and Subsidiaries
Notes to Consolidated Financial Statements (Unaudited)

NOTE 1 BASIS OF PRESENTATION

Overview

Fremont General Corporation (Fremont General or when combined with its subsidiaries, the Company) is a financial services holding company. Fremont General s financial services operations are consolidated within Fremont General Credit Corporation (FGCC), through its California industrial bank subsidiary, Fremont Investment & Loan (FIL). FIL offers certificates of deposit and savings and money market deposit accounts through its 22 retail banking branches in California. FIL s deposit accounts are insured up to the maximum legal limit by the Federal Deposit Insurance Corporation (FDIC). For portions of the nine month period ended September 30, 2007, the Company was engaged in commercial and residential (consumer) real estate lending businesses on a nationwide basis.

Exit from Sub-prime Mortgage Business; Cease and Desist Order. During 2007, the sub-prime residential real estate market experienced a significant deterioration that included increases in borrower delinquencies and a deterioration of credit that resulted in a substantial increase in the amount of loan repurchases and repricings on the Company s residential real estate whole loan sales. These repurchases and repricings were due primarily to early payment defaults and breaches of representations and warranties. As a result of the increase in repurchases and repricings, during the third quarter of 2007, the Company recorded provisions of $5.3 million and $9.0 million to its residential real estate loan valuation and repurchase reserves, respectively, and $523.0 million and $265.6 million, respectively, during the nine months ended September 30, 2007. For further information concerning activity in these reserves during 2007 and the comparable period in 2006 see Note 6.

On March 2, 2007, the Company announced that it intended to exit its sub-prime residential real estate lending operations. This move was consistent with regulatory guidelines issued that day, and was prompted by the Company s receipt on February 27, 2007 of a proposed Cease and Desist Order (the Order) from the FDIC calling for the Company to make a variety of changes designed to restrict the level of lending in its sub-prime residential mortgage business as well as the Company s analysis of the deterioration of the sub-prime residential real estate market. On March 7, 2007, the Company announced that it had ceased entering into new funding commitments with respect to sub-prime mortgage loans, although it would honor remaining outstanding commitments.

On March 7, 2007, Fremont General, FGCC and FIL consented to the Order without admitting to the allegations contained in the Order.

The Order requires, among other things, that FIL make a variety of changes in its sub-prime residential loan origination business and also calls for certain changes in its commercial real estate lending business. As more fully described elsewhere in this report, the Company has exited its sub-prime residential real estate operations and has sold its commercial real estate lending business and related loan portfolio. In addition, the Order requires that FIL adopt a Capital Adequacy Plan to maintain adequate Tier-1 Leverage capital in relation to its risk profile. Further, the Order mandates various specific management requirements, including having and retaining qualified management acceptable to the FDIC and the Department of Financial Institutions of the State of California (DFI), and provides for enhanced regulatory oversight over FIL s operations. The Order is more fully described in a Current Report on Form 8-K filed by the Company on March 7, 2007.

Residential Real Estate Transactions. On March 21, 2007, the Company announced that FIL had entered into whole loan sale agreements to sell approximately $4 billion of its sub-prime residential real estate loans. On April 16, 2007, the Company announced that FIL had entered into an agreement to sell another $2.9 billion of sub-prime residential real estate loans, which represented the majority of the Company s sub-prime residential loans held for sale that had not yet been sold. The Company is in discussions with various parties with respect to the sale of the Company s sub-prime residential loan servicing platform and other assets. There can be no assurances that the Company will be able to enter into any transaction with respect to such business. In addition, given the significant market challenges that currently exist in the residential real estate sector, even if such transactions are completed, there can be no assurances that the consideration received in such sales will provide substantial benefit to the Company s operating results or financial position.

For further information concerning the remaining assets and liabilities of the Company s discontinued residential real estate operations see Note 6.

Commercial Real Estate Transaction. On July 2, 2007, FIL completed the disposition of its commercial real estate lending business and related loan portfolio to *i*Star Financial Inc. (*i*Star) pursuant to an Asset Purchase Agreement entered into on May 21, 2007. FIL sold its entire $6.27 billion commercial real estate loan portfolio and majority of the non-loan assets used in the business to *i*Star and received $1.89 billion in cash plus a $4.2 billion participation interest in the sold portfolio. The $1.89 billion in cash represented 30% of the unpaid principal balance of the loan portfolio as of the closing, net of a purchase discount. The $4.2 billion participation interest in the total loan portfolio represented 70% of the unpaid principal balance of the loan portfolio as of the closing, net of a purchase discount. The participation interest bears interest at LIBOR + 150 basis points. FIL s participation interest in the loan portfolio is governed by a participation agreement pursuant to which FIL is entitled to receive 70% of all principal payments on the loans sold to *i*Star, including with respect to any portion of the unfunded commitments with respect to such loans that are subsequently funded by *i*Star. In connection with the transaction, *i*Star assumed all obligations with respect to the loan portfolio after the closing date (including the obligation to fund approximately $3.72 billion of existing unfunded commitments) and the obligations under certain assumed leases and intellectual property contracts. As of the closing date, *i*Star employed substantially all of the employees previously engaged in the Company s commercial real estate lending business. For further information concerning the results of the sale of the commercial real estate loan portfolio and related assets to *i*Star see Notes 5 and 8.

Third Quarter Operations. As described above, by the beginning of the third quarter of 2007, the Company had disposed of its residential real estate loan origination operations, a significant portion of its remaining residential real estate assets and had completed the sale of its commercial real estate lending business and related loan portfolio. The continuing operations that remained during the third quarter of 2007 consisted primarily of the Company s retail banking operations, which continued to accept and maintain retail deposit accounts. In addition, during the third quarter of 2007, the Company began recognizing interest income on the participation interest in the commercial real estate loan portfolio sold to *i*Star. With respect to its discontinued operations, during the third quarter of 2007 the Company continued to service residential real estate loans and recognize interest income on its remaining residential real estate assets classified as held for sale.

Subsequent Events

Transaction with Gerald J. Ford. On May 21, 2007, Fremont General and FIL entered into an Investment Agreement with an entity controlled by Gerald J. Ford providing for the acquisition by an investor group led by Mr. Ford of a combination of approximately $80 million in exchangeable non-cumulative preferred stock of FIL and warrants to acquire additional common stock of Fremont General. On September 26, 2007, the Company announced that it had been advised by Mr. Ford that, in light of certain developments pertaining to Fremont General and FIL, Mr. Ford was not prepared to consummate such transactions on the terms set forth in the Investment Agreement. The Company said that, while it did not necessarily agree with the factual positions taken by Mr. Ford, it was in discussions with Mr. Ford concerning revised terms under which an entity controlled by Mr. Ford would proceed with an $80 million investment in exchangeable preferred stock of FIL and receive warrants to acquire additional common stock of Fremont General. On October 29, 2007, the Investment Agreement was terminated. On October 30, 2007, the Company announced that it had ceased discussions with Mr. Ford. The Company is continuing to explore strategic alternatives with the assistance of Credit Suisse Securities LLC. There can be no assurances as to whether or when it will be able to enter into an agreement with respect to or complete any such alternative.

Stockholder Rights Plan. On October 23, 2007, Fremont General entered into a Stockholder Rights Plan (the Rights Plan) under which one right was distributed as a dividend for each share of common stock held by stockholders of record as of the close of business on November 2, 2007. The Rights Plan has been adopted as

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a means to assist in the preservation of the use of previously accumulated net operating losses, as described below.

The Company has net operating losses (NOLs) that may in the future offset the Company s taxable income, if any. U.S. federal income tax law imposes significant limitations on the ability of a corporation to use its NOLs to offset income in circumstances where such corporation has experienced a change in ownership. Generally, there is a change in ownership if, at any time, one or more 5% stockholders have aggregate increases in their ownership in the corporation of more than 50 percentage points looking back over the prior three-year period. One of the principal reasons for adopting the Rights Plan is to dissuade investors from aggregating ownership in the Company and triggering such a change in ownership. The Rights Plan is designed to reduce the likelihood of a change in ownership by, among other things, discouraging any person or group from acquiring additional shares of the Company s common stock. The Rights Plan was not adopted in response to any effort to acquire control of the Company.

To help preserve the benefit of the NOLs, the Company intends to submit for stockholder approval at its 2008 Annual Meeting an amendment to its articles of incorporation to restrict certain acquisitions of the Company s common stock so as to reduce the likelihood of triggering a change in ownership as defined for purposes of preserving the NOL. The Board of Directors intends to terminate the Rights Plan if such amendment is approved.

Under the Rights Plan, each right initially will entitle stockholders to purchase a fraction of a share of preferred stock at a purchase price of $12.00, subject to adjustment as provided in the Rights Plan. Subject to the exceptions and limitations contained in the Rights Plan, the rights generally will be exercisable only if a person or group acquires beneficial ownership of 5% or more of the Company s common stock or commences a tender or exchange offer upon consummation of which such person or group would beneficially own 5% or more of the Company s common stock. Unless earlier terminated, the rights will expire on November 2, 2017.

Discontinued Operations

As more fully described above, in March 2007, the Company decided to exit the residential real estate business and to sell substantially all of the assets related to such business. In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144), the Company has classified the residential real estate operations as discontinued operations as the cash flow of the business has been eliminated from its ongoing operations and the Company will no longer have any significant continuing involvement in the business. Therefore, the results of operations, financial position and cash flows of the Company s residential real estate operations are presented separately in the consolidated financial statements and notes as discontinued operations for all periods presented.

When an operation meets the criteria for held for sale accounting as defined in SFAS No. 144, the operation is evaluated to determine whether the carrying value exceeds its fair value less costs to sell. Any loss resulting from the carrying value exceeding the fair value less costs to sell is recorded in the statement of operations in the period the operation meets the criteria for held for sale accounting. Management judgment is required to both assess the criteria required for held for sale accounting as well as to estimate fair value. Changes in the operation could cause it to no longer qualify for held for sale accounting and changes in fair value could result in an increase or decrease to previously recognized losses. For additional information concerning the Company s discontinued operations see Note 6.

General

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The consolidated financial statements include the accounts and operations of Fremont General and its subsidiaries including those variable interest entities where the Company is the primary beneficiary. All intercompany balances and transactions have been eliminated in consolidation.

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that materially affect the reported amounts of assets and liabilities and the

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disclosure of contingent liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates. In the opinion of management, all adjustments considered necessary for the fair presentation of the interim financial statements have been included. See Note 6 for additional information concerning the results of the Company s discontinued operations and Note 8 for information concerning the gain on sale and exit costs related to the disposal of the Company s commercial real estate lending business and related loan portfolio.

The operating results for the nine month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

NOTE 2 RECENT ACCOUNTING STANDARDS

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS No. 155). SFAS No. 155 requires companies to evaluate their interests in securitized financial assets and determine whether the interests are freestanding derivatives or hybrid financial instruments that may be subject to bifurcation. SFAS No. 155 provides companies with relief from having to separately determine the fair value of an embedded derivative that would otherwise be required to be bifurcated from its host contract in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company adopted SFAS No. 155 as of January 1, 2007 without any significant impact on the Company s financial position or results of operations.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 (SFAS No. 156). SFAS No. 156 requires entities to separately recognize a servicing asset or liability when undertaking an obligation to service a financial asset under a servicing contract in certain situations, including a transfer of the servicer s financial assets that meets the requirements for sale accounting. SFAS No. 156 requires that any such servicing asset or liability be initially measured at fair value, if practicable, and then provides the option to either: (1) carry the mortgage servicing rights (MSRs) at fair value with changes in fair value recognized in current period earnings; or (2) continue recognizing periodic amortization expense and assess the MSRs for impairment as originally required by SFAS No. 140. The Company adopted SFAS No. 156 effective January 1, 2007 without any impact; electing to continue to record periodic amortization expense as originally required under SFAS No. 140.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a two-step approach for the recognition and measurement of a tax position taken or expected to be taken in an entity s tax return. The first step in the evaluation of a tax position is recognition: The Company must determine whether it is more likely than not that a given tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In this evaluation the Company must presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position meeting the more-likely-than-not recognition threshold is recorded at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. The Company adopted FIN No. 48 effective January 1, 2007 resulting in a charge to beginning retained earnings of approximately $3.4 million. See Note 9 for further information on the impact of adopting FIN No. 48 and other tax related information.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP and provides for expanded disclosures concerning fair value measurements. SFAS No. 157 retains the exchange price notion in earlier definitions of fair value; however, focuses on the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). SFAS No. 157 also establishes a fair value hierarchy used to classify the source of information used by the entity in fair value measurements. That is, assumptions developed based on market data obtained from independent sources (observable inputs) versus the entity s own assumptions about market assumptions developed based on the best information available in the circumstances (unobservable inputs). The Company is currently evaluating the impact of adopting SFAS No. 157; however, the Company does not believe the adoption will have a significant impact on its financial position or results of operations. SFAS No. 157 is effective for the Company s fiscal year beginning January 1, 2008.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS No. 159). SFAS No. 159 allows entities the option to measure many financial instruments and certain other items at fair value at specified election dates with changes in fair value reported in earnings. The fair value option may be applied on an instrument by instrument basis (with some exceptions), is irrevocable (unless a new election date occurs) and is applied only to entire instruments and not to portions of instruments. The FASB indicated that the objective of this statement is to improve financial reporting by providing entities the opportunity to mitigate volatility in reported earnings that are caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions. The Company is currently evaluating the impact of adopting SFAS No. 159. SFAS No. 159 is effective for the Company s fiscal year beginning January 1, 2008.

NOTE 3 CASH AND CASH EQUIVALENTS

Cash and cash equivalents are summarized in the following table as of the dates indicated:

(Thousands of dollars)	September 30, 2007	December 31, 2006
Cash on hand	**$ 584**	$ 248
Deposits in other financial institutions	**2,520**	118,228
FHLB shareholder transaction account	**10,000**	397,548
Federal Reserve account	**370,699**	2,078
U.S. Government, Agency and money market funds	**2,227,103**	169,545
Short-term money market funds	**47,162**	46,971
Short-term commercial paper		27,024
Total cash and cash equivalents	**$ 2,658,068**	$ 761,642

The FHLB shareholder transaction account represents a short-term interest-bearing account with the Federal Home Loan Bank of San Francisco. The Company s commercial paper holdings have ratings of A1 / P1 / F1 or better. The short-term money market funds have AAA / Aaa money market fund ratings. As of September 30, 2007, $1.3 million in deposits in other financial institutions were restricted. No other cash and cash equivalents were restricted as of September 30, 2007 and December 31, 2006.

NOTE 4 INVESTMENT SECURITIES CLASSIFIED AS AVAILABLE-FOR-SALE

The amortized cost, unrealized gains, unrealized losses and fair value of the Company s investment securities classified as available-for-sale as of September 30, 2007 were as follows:

(Thousands of dollars)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Agency mortgage-backed securities classified as available-for-sale	**$ 1,174,751**	**$ 1,123**	**$ (16)**	**$ 1,175,858**

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There were no realized gains or losses on the available-for-sale securities during the nine months ended September 30, 2007. Unrealized gains or losses are included in other comprehensive income.

NOTE 5 PARTICIPATION INTEREST

As more fully described in Note 1, on July 2, 2007, FIL completed the sale of its commercial real estate lending business and related loan portfolio to *i*Star. FIL sold its entire $6.27 billion commercial real estate loan portfolio and majority of the non-loan assets used in the business to *i*Star and received $1.89 billion in cash plus a $4.2 billion participation interest in the sold portfolio. The terms of the agreement call for *i*Star to provide the Company with principal paydowns on a monthly basis plus interest payments on the unpaid principal balance at LIBOR + 150 basis points. The following table summarizes the activity in the Company s participation interest for the period indicated.

(Thousands of dollars)		Three Months Ended September 30, 2007
Beginning balance	$	
Participation interest received		**4,201,208**
Principal payments		**(576,948)**
Ending balance	$	**3,624,260**

During the three months ended September 30, 2007, the Company recognized $70.7 million in interest income on the participation interest.

NOTE 6 DISCONTINUED OPERATIONS

As more fully described in Note 1, in March 2007, the Company decided to exit the residential real estate business and sell substantially all of the assets related to such business. The Company has determined there are no migration of revenues or costs as defined in EITF 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations (EITF 03-13), since the Company is disposing of substantially all of its residential real estate operations and assets. In addition, although continuing cash flows may occur related to loan repurchases and repricings the Company is obligated to make in subsequent periods under standard industry representations and warranties for its residential real estate whole loan sales, the resolution of these contingencies do not constitute continuing cash flows or continuing involvement as defined in EITF 03-13. Therefore, in accordance with SFAS No. 144, the results of operations, financial position and cash flows of the Company s residential real estate operations are presented separately in the consolidated financial statements and notes as discontinued operations for all periods presented.

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Assets and Liabilities of Discontinued Operations

The major classifications of assets and liabilities of the Company s discontinued operations are summarized as follows as of the dates indicated:

(Thousands of dollars)		September 30, 2007		December 31, 2006
Residential real estate loans held for sale net	**$**	**511,738**	$	4,949,747
Servicing advances		**264,242**		92,175
Mortgage servicing rights net		**47,974**		101,172
Real Estate Owned		**26,532**		12,790
Residual interests in securitized loans at fair value		**16,728**		85,468
Loans receivable		**10,917**		8,568
Accrued interest receivable		**5,118**		18,572
Investment securities classified as available-for-sale		**16,295**		21,282
Other assets		**7,281**		26,146
Total assets to be sold	**$**	**906,825**	$	5,315,920
Loan repurchase reserve	**$**	**100,104**	$	140,923
Premium repurchase and recapture reserves		**61**		8,442
Federal Home Loan Bank advances				1,060,000
Other liabilities		**14,285**		97,840
Total liabilities	**$**	**114,450**	$	1,307,205

Residential Real Estate Loans Held for Sale and Valuation Reserve: Residential real estate loans held for sale are aggregated prior to their sale and are carried at the lower of aggregate cost or estimated fair value less costs to sell. Estimated fair values are based upon current secondary market prices for loans with similar coupons, maturities and credit quality. The following tables detail the residential real estate loans held for sale included in discontinued operations and the valuation reserve to adjust the loans to estimated fair value less costs to sell as of the dates indicated:

Residential Real Estate Loans Held For Sale (Thousands of dollars)		September 30, 2007		December 31, 2006
Loan principal balance:				
First trust deeds	**$**	**836,977**	$	4,843,547
Second trust deeds		**155,335**		345,845

		992,312		5,189,392
Net deferred direct origination costs		**3,682**		38,940
		995,994		5,228,332
Valuation reserve		**(484,256)**		(278,585)
Loans held for sale net	**$**	**511,738**	$	4,949,747
Loans held for sale on non-accrual status	**$**	**221,500**	$	64,652

Valuation Reserve	Three Months Ended September 30,				Nine Months Ended September 30,			
(Thousands of dollars)		2007		2006		2007		2006
Beginning balance	**$**	**481,838**	$	74,433	**$**	**278,585**	$	32,753
Provision		**5,321**		39,820		**522,984**		87,100
Discounted sales		**(103,004)**		(61,928)		**(574,031)**		(111,416)
Charge-offs		**(18,405)**		(4,419)		**(31,356)**		(9,289)
Transfer from repurchase reserve		**118,506**		48,379		**288,074**		97,137
Ending balance	**$**	**484,256**	$	96,285	**$**	**484,256**	$	96,285

In cases where the borrower experiences difficulties and the Company makes certain concessionary modifications to contractual terms (typically a reduction of the interest rate charges), the loan is classified as modified (i.e. restructured) accruing loan if the loan is performing in accordance with the agreed upon modified loan terms and projected cash proceeds are deemed sufficient to repay both principal and interest.

During the third quarters of 2007 and 2006, the Company modified residential real estate loans with a total unpaid principal balance of approximately $22.2 million and $0.0 million, respectively. During the first nine months of 2007 and 2006, the Company modified residential real estate loans with a total unpaid principal balance of approximately $28.9 million and $0.0 million, respectively. Modified residential real estate loans on accrual status as of September 30, 2007 and 2006 was $10.0 million and $0.0 million, respectively.

Servicing Advances: As a loan servicer, the Company is required to make certain advances on specific loans it is servicing to the securitization trusts that hold the loans, and loans owned by the Company, to the extent such advances are deemed collectible by the Company, from collections related to the individual loans. The total amount of servicing advances outstanding was $264.2 million and $92.2 million as of September 30, 2007 and December 31, 2006, respectively.

Mortgage Servicing Rights: The following table summarizes the activity in the Company s mortgage servicing rights asset within discontinued operations for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Thousands of dollars)	2007	2006	2007	2006
Beginning balance	**$ 75,505**	$ 62,739	**$ 101,677**	$ 46,022
Additions (sales)		35,119	**5,495**	68,739
Amortization	**(7,302)**	(12,975)	**(38,969)**	(29,878)
Ending balance before valuation allowance	**68,203**	84,883	**68,203**	84,883
Valuation allowance:				
Beginning balance	**(12,735)**		**(505)**	
Provision for temporary impairment	**(7,494)**		**(19,724)**	
Ending balance	**(20,229)**		**(20,229)**	
Mortgage servicing rights net	**$ 47,974**	$ 84,883	**$ 47,974**	$ 84,883
Estimated fair value	**$ 53,279**	$ 90,967	**$ 53,279**	$ 90,967

The key economic assumptions used in subsequently measuring the fair value of the Company s MSRs as of the dates indicated are as follows:

	September 30, 2007	December 31, 2006

Weighted-average life (years)	**1.8**	1.4
Weighted-average annual prepayment speed	**25.4%**	38.8%
Weighted-average annual discount rate	**19.8%**	19.6%

Residual Interests in Securitized Loans: The following table summarizes the activity of the Company s retained residual interests within discontinued operations for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Thousands of dollars)	2007	2006	2007	2006
Beginning balance at fair value	**$ 34,932**	$ 107,535	**$ 85,468**	$ 170,723
Additions (sales)		22,642		(41,994)
Interest accretion	**7,184**	8,946	**21,409**	41,705
Cash received	**(19,240)**	(2,401)	**(72,634)**	(33,993)
Change in unrealized losses	**(1,999)**	(4,023)	**(8,408)**	2,010
Other-than-temporary impairment	**(4,149)**		**(9,107)**	(5,752)
Ending balance at fair value	**$ 16,728**	$ 132,699	**$ 16,728**	$ 132,699

The following table summarizes delinquencies and credit losses for the loans underlying the Company s outstanding securitization transactions as of the dates indicated:

(Thousands of dollars)	September 30, 2007	December 31, 2006
Original principal amount of loans securitized	**$ 17,536,329**	$ 17,536,329
Current principal amount of loans securitized	**$ 8,809,326**	$ 10,938,440
Current delinquent principal amount (over 60 days)	**$ 1,891,265**	$ 1,142,794
Inception to date credit losses (net of recoveries)	**$ 188,577**	$ 53,241

Key economic assumptions used in subsequently measuring the fair value of the Company s residual interests as of the dates indicated are as follows:

	September 30, 2007	December 31, 2006
Weighted-average life (years)	**2.6**	2.5
Weighted-average annual prepayment speed	**28.2%**	25.0%
Weighted-average lifetime credit losses	**5.7%**	5.5%
Weighted-average annual discount rate	**35.0%**	24.0%

Loan Repurchase Reserve: As the residential real estate loans held for sale are sold, the Company makes standard industry representations and warranties about the loans. The Company may have to subsequently repurchase certain loans due to defects that occurred in the origination of the loans. During the third quarters of 2007 and 2006, the Company repurchased a total of $279.1 million and $294.2 million in loans, respectively. During the first nine months of 2007 and 2006, the Company repurchased a total of $931.8 million and $532.8 million in loans, respectively. The following table summarizes the activity in the repurchase reserve related to residential loans which is included in discontinued operations for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Thousands of dollars)	2007	2006	2007	2006
Beginning balance	**$ 214,638**	$ 57,586	**$ 140,923**	$ 14,556
Provision	**9,047**	31,184	**265,636**	141,479
Charge-offs for loan repricing	**(5,075)**	(6,199)	**(18,381)**	(24,706)
Transfer to valuation reserve	**(118,506)**	(48,379)	**(288,074)**	(97,137)

Ending balance	**$ 100,104**	$ 34,192	**$ 100,104**	$ 34,192

Premium Repurchase and Recapture Reserve: The Company also maintains a reserve for premium recapture that represents the estimate of probable refunds of premiums received on previously completed loan sales (either due to early loan prepayments or for certain loans repurchased from prior sales) that are expected to occur under the provisions of the various agreements entered into for the sale of its residential real estate loans held for sale. The following table summarizes the activity in the premium recapture reserve within discontinued operations for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Thousands of dollars)	2007	2006	2007	2006
Beginning balance	**$ 436**	$ 10,661	**$ 8,442**	$ 4,259
Provision for premium recapture on repurchased loans	**(11,523)**	2,858	**(20,065)**	12,629
Provision for standard premium recapture		2,855	**(568)**	10,484
Refunds	**11,148**	(10,041)	**12,252**	(21,039)
Ending balance	**$ 61**	$ 6,333	**$ 61**	$ 6,333

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Operating Results of Discontinued Operations

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Thousands of dollars)	2007	2006	2007	2006
Interest income	**$ 16,954**	$ 144,379	**$ 217,656**	$ 484,841
Non-interest income	**3,142**	4,918	**(865,124)**	22,538
Revenues from discontinued operations	**$ 20,096**	$ 149,297	**$ (647,468)**	$ 507,379
Loss on sale of discontinued operations	**$ (4,141)**	$ (9,623)	**$ (881,116)**	$ (16,425)
Interest income	**16,954**	144,379	**217,656**	484,841
Interest expense	**(15,357)**	(86,270)	**(146,361)**	(262,090)
Provision for loan loss	**15**	(5)		8
Loan servicing income	**26,647**	26,427	**90,314**	71,258
Mortgage servicing rights amortization and impairment provision	**(14,796)**	(12,975)	**(61,893)**	(29,878)
Impairment on residual interests	**(5,148)**		**(15,479)**	(5,752)
Other non-interest income	**580**	1,089	**3,050**	3,335
Compensation and related	**(13,959)**	(29,868)	**(83,362)**	(94,125)
Occupancy	**(4,879)**	(4,929)	**(19,725)**	(13,885)
Other non-interest expense	**(9,291)**	(16,391)	**(65,213)**	(42,760)
Income (loss) from discontinued operations	**(23,375)**	11,834	**(962,129)**	94,527
Income tax (expense) benefit	**9,480**	(4,986)	**92,356**	(38,101)
Income (loss) from discontinued operations, net of income taxes	**$ (13,895)**	$ 6,848	**$ (869,773)**	$ 56,426

The loss from discontinued operations, net of income taxes, was $13.9 million for the third quarter of 2007, representing a $0.18 diluted loss per share, compared to income from discontinued operations, net of income taxes, of $6.8 million, or $0.09 diluted income per share for the third quarter of 2006. During the first nine months of 2007, the loss from discontinued operations, net of income taxes, was $869.8 million, representing a $11.25 diluted loss per share, compared to income from discontinued operations, net of income taxes, of $56.4 million, or $0.74 diluted income per share for the comparable period in 2006.

In accordance with SFAS No. 128, Earnings per Share, for the three and nine months ended September 30, 2007, the Company calculated the diluted loss per share from discontinued operations, net of income taxes, using the same number of potential common shares used in computing the diluted income per share from continuing operations even though the results were antidilutive with respect to the discontinued operations basic per share amounts.

During the third quarter of 2007, the Company recorded a realized loss of $4.1 million, net of valuation reserves, related to the sale of $234.9 million of residential real estate loans held for sale. During the nine months ended September 30, 2007, the Company recognized a loss of $881.1 million, net of valuation reserves related to the sale of

$8.75 billion of residential real estate loans held for sale. Expense provisions related to the residential real estate loan valuation, repurchase and premium recapture reserves are included in these losses. In addition, during third quarter and the first nine months of 2007, the Company recognized $664,000 and $39.4 million, respectively, in adjustments to write down the carrying value of the residential real estate held for sale assets to their estimated fair value less costs to sell.

During the third quarters of 2007 and 2006, the Company recognized $8.9 million and $123.0 million, respectively, in interest income on the residential real estate loan portfolio. During the nine months ended September 30, 2007 and 2006, the Company recognized $195.4 million and $396.5 million, respectively, in interest income on the residential real estate loan portfolio.

During the third quarter of 2007, the Company continued to service residential real estate loans, recognizing loan servicing income of $26.6 million as compared to $26.4 million during the third quarter of 2006. During the nine months ended September 30, 2007 and 2006, the Company recognized $90.3 million and $71.3 million, respectively, in loan servicing income. The Company was servicing to maturity $15.38 billion and $18.12 billion in principal balance of loans as of September 30, 2007 and December 31, 2006, respectively.

The loss from discontinued operations for the three and nine months ended September 30, 2007 includes $4.8 million and $10.1 million, respectively, in charges for one time severance payments paid to employees of the residential real estate loan origination operations and related support staff. In addition, during the same periods, the Company recorded $4.0 million and $14.7 million, respectively, of charges for lease termination costs related to the Company s residential real estate loan origination offices.

During the nine months ended September 30, 2007, cash flows related to residential real estate loan originations and proceeds realized on the sale of such loans were $3.89 billion and $7.81 billion, respectively, and during the nine months ended September 30, 2006, such cash flows were $25.84 billion and $25.31 billion, respectively. These amounts are included in cash flows from operating activities in the Company s consolidated statements of cash flows.

NOTE 7 REAL ESTATE OWNED

The Company s real estate owned (REO) consists of property acquired through or in lieu of foreclosure on loans secured by real estate. REO is reported in the financial statements at the lower of cost or estimated realizable value (net of estimated costs to sell). REO consisted of the following as of the dates indicated:

(Thousands of dollars)	September 30, 2007	December 31, 2006
Commercial real estate	**$**	$ 299
Valuation reserve		
Real estate owned net	**$**	$ 299

During the third quarter of 2007, the Company disposed of its remaining commercial REO property.

NOTE 8 SALE OF COMMERCIAL REAL ESTATE LOANS AND EXIT AND DISPOSAL COSTS

As more fully described in Note 1, the Company completed the sale of its entire $6.27 billion commercial real estate loan portfolio and majority of the non-loan assets used in the business to *i*Star in July 2007, and received cash of $1.89 billion and a 70% participation interest of $4.2 billion in the loans sold. Due to the participation, cash flows from the component will not be eliminated from the Company s ongoing operations. Because the Company expects significant cash inflows will be received as a result of the continuation of activities between itself and the commercial real estate component, the sale does not result in the classification of the commercial real estate operation as discontinued, as defined by EITF No. 03-13. Based on management s decision to sell the commercial loan portfolio in the first quarter of 2007, the Company reclassified the commercial real estate loans from held for investment to held for sale. The Company recorded a $65.6 million gain during the third quarter of 2007 related to the sale of the commercial real estate