NEW CENTURY FINANCIAL CORP
Form 10-K
March 16, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2005

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 001-32314

NEW CENTURY FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Maryland	**56-2451736**
(State or other jurisdiction incorporation or organization)	*(I. R. S. Employer Identification Number)*
18400 Von Karman, Suite 1000, Irvine, California	**92612**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:
(949) 440-7030

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
9.125% Series A Cumulative Redeemable Preferred 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 þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the 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 (§229.405 of this chapter) 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The aggregate market value of common stock held by non-affiliates, based on the closing price of the common stock of the registrant on the last business day of the most recently completed second fiscal quarter as reported on the New York Stock Exchange, was $2.3 billion. All executive officers and directors of the registrant and all persons filing a Schedule 13D with the Securities and Exchange Commission in respect to registrant s common stock have been deemed, solely for the purpose of the foregoing calculations, to be affiliates of the registrant.

As of March 1, 2006, the Registrant had 55,984,299 shares of common stock outstanding.

Certain information required for Part III of this report is incorporated herein by reference to the proxy statement for the 2006 annual meeting of the Company s stockholders.

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PART I

Item 1. *Business*

General

New Century Financial Corporation is a real estate investment trust, or REIT, that, through its taxable REIT subsidiaries, operates one of the nation s largest mortgage finance companies. We began originating and purchasing loans in 1996, and, in the fourth quarter of 2004, we began operating our business as a REIT. We originate and purchase primarily first mortgage loans nationwide. Historically, we have focused on lending to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers. In September 2005, we acquired a mortgage origination platform from RBC Mortgage Company, or RBC Mortgage, that expands our offerings to include conventional mortgage loans, including Alt-A mortgage loans, loans insured by the Federal Housing Administration, or FHA, and loans guaranteed by the Veterans Administration, or VA. A significant portion of the conventional loans, which are generally referred to as conforming loans, we produce qualify for inclusion in guaranteed mortgage securities backed by the Federal National Mortgage Association, or Fannie Mae, or the Federal Home Loan Mortgage Corp., or Freddie Mac. At the same time, some of the conventional loans we produce either have an original loan amount in excess of the Fannie Mae and Freddie Mac loan limit for single-family loans or otherwise do not meet Fannie Mae or Freddie Mac guidelines.

We have historically sold our loans through both whole loan sales and securitizations structured as sales. Since 2003, we have also retained a portion of our loan production for investment on our balance sheet through securitizations structured as financings rather than sales. Our decisions regarding secondary marketing transactions in 2006 will be based on market conditions and our ability to access external sources of capital. We do not currently intend to structure any securitizations as sales in 2006.

On April 5, 2004, the board of directors of New Century TRS Holdings, Inc., or New Century TRS, formerly known as New Century Financial Corporation, approved a plan to change its capital structure to enable it to qualify as a REIT for U.S. federal income tax purposes. On April 12, 2004, New Century TRS formed New Century Financial Corporation, or New Century, a Maryland corporation formerly known as New Century REIT, Inc.

Pursuant to the merger that implemented the restructuring of New Century TRS in order for it to qualify as a REIT, New Century became the publicly-traded parent listed on the New York Stock Exchange, or NYSE, that succeeded to and continued to operate substantially all of the existing businesses of New Century TRS and its subsidiaries.

In this annual report on Form 10-K, unless the context suggests otherwise, for time periods before October 1, 2004, the terms the company, our company, we, our and us refer to New Century TRS and its subsidiaries, and f time periods on and after October 1, 2004, the terms the company, our company, we, our and us refer to New Ce and its subsidiaries, including New Century TRS.

Business Strategy

Our business objective is to deliver an attractive return to our stockholders, including a stable dividend. Our strategies to achieve this objective are:

- *Delivering consistently strong operating performance, including taxable REIT subsidiary (TRS) and mortgage loan portfolio earnings.* We intend to maintain, if not increase, our mortgage loan portfolio by executing securitizations of loans originated through our TRS, and structuring those securitizations as financings. As we increase our mortgage loan portfolio, our interest income will increase and, in turn, we will have a larger pool of earnings that can be distributed to our stockholders. Alternatively, if we structure such securitizations in our TRS, the resulting earnings can be retained to strengthen our TRS origination franchise. We expect that our capacity to originate loans at our TRS will enable us to grow

our mortgage loan portfolio by providing us with a significant volume of loans at a lower cost and with greater reliability than if we purchased our mortgage loan portfolio from a third party.

Broadening the mortgage products and services available through each of our delivery channels. We plan to grow our production franchise by expanding our product and service offerings through each of our delivery channels, as discussed below. As a result of our acquisition of the loan origination platform of RBC Mortgage, we now offer non-prime mortgage loan products through all of our delivery channels and intend to offer prime and Alt-A products through all of our delivery channels by mid-2006. By expanding the product lines available through each of our delivery channels, we believe we can profitably gain market share despite the projected contraction of overall mortgage industry volume in 2006.

Increasing productivity while reducing costs to enhance our competitive position in the industry. In the fourth quarter of 2005, the costs to originate our loans, which we refer to as loan acquisition costs, reached a record low as a result of our concerted efforts to improve our profitability. In addition, our 2005 loan production volume was $56.1 billion, our tenth consecutive record year of loan production. Our strong and scalable origination platform and low loan acquisition costs enable us to react to market conditions and allow us the opportunity to earn substantial income and build retained earnings and liquidity, enhancing our competitive position in the industry.

Actively managing our mortgage loan portfolio. We seek to actively manage the composition, as well as interest rate and credit risks relating to our mortgage loan portfolio, in an effort to generate an attractive risk-adjusted return to stockholders. We continue to use hedge instruments to attempt to reduce the interest rate exposure that results from financing fixed-rate assets with floating-rate liabilities. We also actively monitor our mortgage loan portfolio through early detection and management of probable delinquencies.

Maintaining a strong capital and liquidity base. We continue to prudently manage our capital and liquidity levels and may increase our capital and liquidity by accessing the capital markets, when appropriate. We also seek to maintain available capacity under our credit facilities and may enhance our capital and liquidity positions by retaining some or all of our earnings in our TRS.

Competitive Advantages

We believe the following competitive strengths distinguish our business model from those of other mortgage REITs and residential mortgage lenders and enable us to implement our business strategy:

One of the largest mortgage REIT portfolios. We have one of the largest portfolios of residential mortgage loans of any REIT. In 2005, our mortgage portfolio provided a significant portion of our earnings.

Leading mortgage loan origination franchise. New Century Mortgage Corporation and Home123 Corporation, our operating taxable REIT subsidiaries, together represent one of the nation s largest mortgage finance companies when measured by loan production volume for the year ended December 31, 2005. We are authorized to lend in all 50 states and have a leading market presence through a wholesale network of more than 47,000 approved independent mortgage brokers and our retail network of 222 branch offices, housing our consumer-direct channel and our builder/realtor channel. Our taxable REIT subsidiaries have the potential to generate significant earnings through our mortgage loan origination franchise.

Low-cost producer. Our ability to originate mortgage loans at a low cost allows us to achieve greater profitability than many of our competitors. In addition, we are able to build our portfolio by retaining self-originated loans, rather than engaging in large bulk secondary market purchases, providing us with a competitive advantage over REITs without origination capabilities.

Operational flexibility. Our structure and business strategy provide us with the flexibility to both securitize a portion of our loan originations for our portfolio and sell the balance for cash. We believe

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that this flexibility allows us to provide a broader product offering, better manage our cash flows and respond to changing conditions in the secondary market environment, thus enhancing returns to our stockholders.

Long-standing institutional relationships. We have developed long-standing relationships with a variety of institutional loan buyers, including Credit Suisse First Boston (DLJ Mortgage Capital, Inc.), Goldman Sachs, JPMorgan Chase, Lehman Brothers, Morgan Stanley, Residential Funding Corporation and UBS Real Estate Securities Inc. These loan buyers regularly bid on and purchase large loan pools from us, and we frequently enter into committed forward loan sale agreements with them. In addition, we have developed relationships with a variety of institutional lenders who provide reliable and stable sources of warehouse financing, including Bank of America NA, Barclays Bank PLC, Bear Stearns Mortgage Capital Inc., Citigroup Global Markets Realty Corp., Credit Suisse First Boston Mortgage Capital LLC, Deutsche Bank Securities Inc., IXIS Real Estate Capital Inc. (formerly known as CDC Mortgage Capital Inc.), Morgan Stanley Mortgage Capital Inc. and UBS Real Estate Securities.

Automated credit grading capability. We have created a proprietary automated credit grading and pricing methodology that we believe gives us the ability to more effectively evaluate credit risk and more efficiently price our products, as validated by our historical loan performance.

Reputation for high quality customer service. We believe our origination process is easier for our borrowers and brokers to use than the origination processes of most of our competitors because of our ability to provide quick responses and consistent and clear procedures, with an emphasis on ease of use through technology, including our FastQual® system, a Web-based underwriting engine.

Management experience and depth. The members of our senior management team have many years of experience in the mortgage finance sector, with substantial experience addressing the challenges posed by a variety of interest rate environments, including growing an origination franchise, managing credit risk and developing strong capital market relationships.

Investment and Operational Policies

Portfolio Strategy

One of our strategies is to maintain a portfolio of mortgage loans through securitizations structured as financings. Our securitizations are typically structured as collateralized mortgage obligations, or CMOs, rather than real estate mortgage investment conduits, or REMICs. Securitizations structured as financings remain on our consolidated balance sheet as an asset and the underlying bonds are reported as a liability. Consequently, we record interest income generated by the mortgage loans and recognize interest expense on the related financings over the life of the mortgage loan pool, rather than generate a gain or loss at the time of the securitization. Our expected securitization activity for 2006 will be based primarily on secondary market conditions and our ability to access external sources of capital.

A substantial portion of the net interest income generated by our securitized loans is based upon the difference between the weighted average interest earned on the mortgage loans and the interest paid to holders of the bonds collateralized by our loans. The net interest income we receive from the securitizations structured as financings is affected by the current level of the London Inter-Bank Offered Rate, or LIBOR, because the holders of the applicable securities are generally paid based on an adjustable LIBOR-based yield. Therefore, an increase in LIBOR reduces the net interest income we receive from, and the value of, these mortgage loans. In addition, the net interest income we receive from securitizations will be reduced if there are a significant number of defaults on repayments or prepayments of loans with interest rates that are high relative to the rest of the asset pool. We attempt to mitigate at least a portion of this net interest margin variability through various hedging activities described below.

We use leverage to increase our mortgage loan portfolio by financing the portfolio through securitizations structured as financings. We generally target our outstanding borrowings, including these financings, at roughly 12 to 14 times the amount of our consolidated equity capital, although our actual leverage ratio may

vary from time to time depending on market conditions and other factors deemed relevant by our management and board of directors.

Hedging policy

We intend to use a variety of risk management strategies to monitor and address interest rate risk. We believe that these strategies will allow us to monitor and evaluate our exposure to interest rates and to manage the risk profile of our mortgage loans held for investment, mortgage loans held for sale and our residual interests in securitizations in response to changes in market conditions. As part of our interest rate risk management process, we may continue to use derivative financial instruments such as Euro Dollar futures contracts, interest rate cap agreements and interest rate swap agreements and may start using Treasury futures and options on interest rates. We may also use other hedging instruments including mortgage derivative securities, as necessary. These derivative instruments currently have an active secondary market, and are intended to offset potential reduced income and cash flow under certain interest rate environments. Hedging strategies involve transaction and other costs. We engage in hedging for the sole purpose of protecting against interest rate risk and not for the purpose of speculating on changes in interest rates.

Financing Policy

If our board of directors determines that additional financing is required, we may raise the funds through additional equity offerings, debt financings, retention of cash flow (subject to provisions in the Internal Revenue Code of 1986, as amended, or the Code, concerning distribution requirements and taxability of undistributed REIT taxable income) or a combination of these methods. In the event that our board of directors determines to raise additional equity capital, it has the authority, without stockholder approval, subject to applicable law and NYSE regulations, to issue additional common stock or preferred stock in any manner and on terms and for consideration it deems appropriate up to the amount of authorized stock set forth in our charter.

Borrowings may be in the form of bank borrowings, secured or unsecured, and publicly or privately placed debt instruments, purchase money obligations to the sellers of assets, long-term, tax-exempt bonds or other publicly or privately placed debt instruments, financing from banks, institutional investors or other lenders, and securitizations, including collateralized debt obligations, any of which indebtedness may be unsecured or may be secured by mortgages or other interests in the assets. Such indebtedness may entail recourse to all or any part of our assets or may be limited to the particular assets to which the indebtedness relates. We will enter into collateralized borrowings only with institutions we believe are financially sound and that are rated investment grade by at least one nationally recognized rating agency. We have authority to offer New Century common stock or other equity or debt securities in exchange for property and to repurchase or otherwise reacquire our securities or any other securities and may engage in any of these activities in the future, subject to applicable law.

Our Mortgage Loan Origination Franchise

We originate and purchase mortgage loans through two divisions our Wholesale Division and our Retail Division. Our Wholesale Division originates and purchases loans through a network of independent mortgage brokers and correspondent lenders solicited by our account executives. Our account executives provide on-site customer service to brokers to facilitate the funding of loans. The Wholesale Division operates under the name New Century Mortgage Corporation and originates mortgage loans through its FastQual Web site at *www.newcentury.com,* where a broker can upload a loan request and receive a response generally within 12 seconds. Our Retail Division operates under the name Home123 Corporation and originates loans through a consumer-direct channel and a builder/realtor channel. The Retail Division is supported by 222 branch offices and a central telemarketing unit. Leads for the consumer-direct channel are generated through radio, direct mail, telemarketing, television advertising and the Internet. Our builder/realtor channel is based on relationships that are either referred or solicited.

Most of our loan production consists of subprime mortgage loans originated through our Wholesale Division. Subprime mortgage loans are made to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers. Our acquisition of the mortgage origination platform of RBC Mortgage has expanded our product offerings to include conventional mortgage loans, including Alt-A mortgage loans, loans insured by the FHA and loans guaranteed by the VA.

For 2005, our Wholesale Division originated $49.2 billion in mortgage loans, or 87.7% of the total mortgage loans we originated, and our Retail Division originated $6.9 billion in mortgage loans, or 12.3% of the total mortgage loans we originated.

Our Wholesale Division

As of December 31, 2005, our Wholesale Division operated through 35 regional operating centers located in 18 states and employed 989 account executives. As of December 31, 2005, we had approved more than 47,000 mortgage brokers to submit loan applications to us. During this period, our 10 largest producing brokers originated 5.6% of our wholesale production.

We have designed and implemented a procedure for qualifying, approving and monitoring our network of approved mortgage brokers. We require the brokers to complete an application that requests general business information and to provide copies of all required licenses. Upon receipt of the application and supporting documentation, our Broker Services Department examines the materials for completeness and accuracy. Our Broker Services Department then independently verifies the information contained in the application through (i) a public records Web site to verify the validity and status of licenses, and (ii) the Mortgage Asset Research Institute, or MARI, which provides background information from both the public and private sectors.

To be approved, a broker must enter into a standard broker agreement with us pursuant to which the broker agrees to abide by the provisions of our Policy on Fair Lending and our Broker Code of Conduct. Each broker also agrees to comply with applicable state and federal lending laws and agrees to submit true and accurate disclosures with regard to loan applications and loans. In addition, we employ a risk management team that regularly reviews and monitors the loans submitted by our brokers.

In wholesale loan originations, the broker s role is to identify the applicant, assist in completing the loan application form, gather necessary information and documents and serve as our liaison with the borrower through our lending process. We review and underwrite the application submitted by the broker, approve or deny the application, set the interest rate and other terms of the loan and, upon acceptance by the borrower and satisfaction of all conditions imposed by us, fund the loan. Because brokers conduct their own marketing and employ their own personnel to complete loan applications and maintain contact with borrowers, originating loans through our Wholesale Division allows us to increase loan volume without incurring the higher marketing, labor and other overhead costs associated with increased retail originations.

Mortgage brokers can submit loan applications through an account executive or through FastQual, our Web-based loan underwriting engine, at *www.newcentury.com.*

In either case, the mortgage broker will forward the original loan package to the closest regional operating center where the loan is logged in for regulatory compliance purposes and approved or denied within 24 hours of receipt in most cases. If approved, we issue a conditional approval to the broker with a list of specific conditions that have to be met (for example, credit verifications and independent third-party appraisals) and additional documents to be supplied prior to the funding of the loan. An account manager and account executive work directly with the submitting mortgage broker who originated the loan to collect the requested information and to meet the underwriting conditions and other requirements. In most cases, we fund loans within 30 days from the date of our approval of an application.

FastQual generally provides the broker with a response in less than 12 seconds. Loan information from the brokers own loan operating systems can be automatically uploaded to FastQual. The system provides all loan products for which the borrower qualifies, enabling brokers to offer their customers many options. Our

FastQual Web site enables mortgage brokers to evaluate loan scenarios for borrowers, submit loan applications, order credit reports, automatically credit grade the loan, obtain pricing and track the progress of the loan through funding.

Our Wholesale Division also purchases funded loans on an individual or flow basis from independent mortgage bankers and financial institutions known as correspondent lenders. We review an application for approval from each lender that seeks to sell us a funded loan. We also review their financial condition and licenses. We require each mortgage banker to enter into a purchase and sale agreement with us containing customary representations and warranties regarding the loans the mortgage banker will sell to us. These representations and warranties are comparable to those given by us to the purchasers of our loans. Once the correspondent lender is approved, we re-underwrite each loan we purchase from them.

The following table sets forth selected information relating to loan originations and purchases through our Wholesale Division during the periods shown:

	For the Quarters Ended			
	March 31, 2005	**June 30, 2005**	**September 30, 2005**	**December 31, 2005**
Principal balance of originations and purchases (in thousands)	$ 9,073,489	12,131,216	14,859,085	13,160,531
Average principal balance of loans originated and purchased (in thousands)	$ 185	184	185	187
Combined weighted average initial loan-to-value ratio(1)	81.3%	81.8%	81.4%	80.8%
Percent of loans secured by first mortgages	94.9%	93.3%	93.0%	92.9%
Property securing mortgage loans:				
Owner occupied	92.7%	93.9%	94.4%	93.7%
Non-owner occupied	7.3%	6.1%	5.6%	6.3%

(1) Weighted average LTV is the LTV of the first lien mortgages and combined LTV of the second lien mortgages.

Our Retail Division

In May 2004, we acquired the rights to Home123, a new brand identity and customer value proposition for our Retail Division. In the acquisition, we purchased the rights to the name Home123 and other brand assets including a loan origination center in Morris Plains, New Jersey, the Home123.com Web site address and the 1-800-HOME123 phone number. In order to facilitate a simple loan origination process, Home123 provides customers with the following tools to inform them about what they can expect throughout the loan process: (i) A Home123 Loan Tool Kit^{SM}, which contains information that assists a customer though the loan process, including mortgage calculators, available through Home123.com or on CD-ROM; (ii) a Loan Blueprint Calendar^{SM}, which is an automated online calendar that tracks the loan application allowing the customer and the loan advisor to understand the status of the loan application throughout the process; and (iii) a loan advisor that acts as the single point of contact for the borrower to help make the loan process as seamless as possible.

In connection with our acquisition of the mortgage loan origination platform from RBC Mortgage, we launched a builder/realtor channel as part of our Retail Division and expanded our product offerings to include conventional mortgage loans, loans insured by the FHA and loans guaranteed by the VA. Through the loan origination platform,

prime credit quality first-lien mortgage loans, both conforming and nonconforming, are secured by one-to-four family residences. Conforming conventional loans qualify for inclusion in guaranteed mortgage securities backed by Fannie Mae or Freddie Mac. Nonconforming conventional loans

either have an original loan amount in excess of the Fannie Mae and Freddie Mac loan limit for single-family loans or otherwise do not meet Fannie Mae or Freddie Mac underwriting guidelines. As a subset of nonconforming conventional loans, we offer an Alt-A adjustable-rate mortgage loan product with a reduced documentation feature to borrowers who satisfy prescribed FICO, LTV and loan purpose criteria. In addition to first-lien mortgage loans, we offer prime credit quality loans secured by second liens on one-to-four family residences, including home equity lines of credit.

We expect to grow our Retail Division through the value proposition of the Home123 brand, supported by our other retail marketing efforts. By creating a direct relationship with the borrower, retail lending provides greater potential for repeat business and greater control over the lending process. Loan origination fees we collect contribute to profitability and cash flow and partially offset the higher costs of retail lending.

As of December 31, 2005, our Retail Division, including our central retail telemarketing unit, employed approximately 1,747 retail loan officers located in two regional processing centers and 222 sales offices.

The following table sets forth selected information relating to loan originations through our Retail Division during the periods shown:

	For the Quarters Ended			
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
Principal balance of originations and purchases (in thousands)	$ 1,178,078	1,312,954	1,852,513	2,540,375
Average principal balance of loans originated and purchased (in thousands)	$ 147	151	154	159
Combined weighted average initial loan-to-value ratio(1)	78.5%	78.9%	78.8%	78.7%
Percent of loans secured by first mortgages	98.8%	98.2%	96.7%	94.7%
Property securing mortgage loans:				
Owner occupied	96.6%	96.9%	95.9%	94.8%
Non-owner occupied	3.4%	3.1%	4.1%	5.2%

(1) Weighted average LTV is the LTV of the first lien mortgages and combined LTV of the second lien mortgages.

Wholesale Marketing

Our Wholesale Division s marketing strategy focuses on the sales efforts of its account executives and on providing prompt, consistent service to mortgage brokers and other customers. Our Wholesale Division supplements its strategy with direct mail, e-mail and fax programs to brokers, advertisements in trade publications, in-house production of collateral sales material, seminar sponsorships, tradeshow attendance, periodic sales contests and its Web site, *www.newcentury.com.*

Retail Marketing

Our retail consumer-direct channel solicits prospective borrowers through a variety of direct response advertising methods, such as purchased leads from aggregators, radio advertising, direct mail, search engine placement, banner ads, e-mail campaigns and links to related Web sites. The channel relies primarily on Internet lead acquisition, targeted direct mail, outbound telemarketing, television, radio and Internet advertisements to attract borrowers. Our

television and radio advertisements are handled by an outside advertising agency that creates our advertisements and buys our television and radio time. Our direct mail and lead acquisition programs are managed by a centralized staff who create a targeted lead list for each branch

market and oversee the completion of mailings by a third-party mailing vendor. All calls or written inquiries from potential borrowers are tracked centrally and then forwarded to a branch location and handled by branch loan officers.

The direct mail program uses the Retail Division s Web site, www.Home123.com, to provide information to prospective borrowers and to allow them to complete a brief or mini application online. Under the Central Telemarketing Program, the telemarketing staff solicits prospective borrowers, makes a preliminary evaluation of the value and type of property, and then refers qualified leads to loan officers in the retail branch closest to the customer. Our builder/realtor channel is based on relationships that are either referred or solicited.

Underwriting Standards

Our loan origination standards and procedures are designed to produce high quality loans. These standards and procedures encompass underwriter qualifications and authority levels, appraisal review requirements, fraud prevention, funds disbursement controls, training of our employees and ongoing review of our employees work. We help to ensure that our origination standards are met by employing accomplished and seasoned managers, underwriters and processors and through the extensive use of technology. We also have a comprehensive training program for the continuing development of both our existing staff and new hires. In addition, we employ proprietary underwriting systems in our loan origination process that improve the consistency of underwriting standards, assess collateral adequacy and help to prevent fraud, while at the same time increasing productivity.

A qualified independent appraiser inspects and appraises each mortgage property and gives an opinion of value and condition. Following each appraisal, the appraiser prepares a report that includes a market value analysis based on recent sales of comparable homes in the area and, when appropriate, replacement cost analysis based on the current cost of constructing a similar home. All appraisals must conform to the Uniform Standards of Professional Appraisal Practice adopted by the Appraisal Foundation s Appraisal Standards Board and are generally on forms acceptable to Fannie Mae and Freddie Mac. Our underwriting guidelines require a review of the appraisal by one of our qualified employees or by a qualified review appraiser that we have retained. Our underwriting guidelines then require our underwriters to be satisfied that the value of the property being financed, as indicated by the appraisal, would support the requested loan amount.

Most of our conventional loans conform to Fannie Mae, Freddie Mac, FHA, or VA standards, and our other non-conforming prime grade loans meet overall industry standards for loan documentation and borrower characteristics. The underwriting guidelines for conventional conforming loans comply with the guidelines established by Fannie Mae or Freddie Mac. Our underwriting guidelines for FHA-insured or VA-guaranteed mortgage loans comply with guidelines established by the U.S. Department of Housing and Urban Development, or HUD, and the VA, as applicable. Non-conforming prime grade mortgage loans originated through our mortgage loan origination platform acquired from RBC Mortgage must also meet overall industry standards for loan documentation and borrower characteristics so that these loans are saleable in the secondary market.

We periodically evaluate and modify our underwriting guidelines. We also adopt new underwriting guidelines appropriate to new loan products we may offer.

Income Documentation

Our underwriting guidelines include three levels of income documentation requirements, referred to as the full documentation, limited documentation and stated income documentation programs.

Under the full documentation program, we generally require applicants to submit two written forms of verification, or 12 or more consecutive monthly bank statements on their individual or business bank accounts, showing stable income for at least 12 months.

Under the limited documentation program, we generally require applicants to submit six consecutive monthly bank statements on their individual bank accounts.

Under the stated income documentation program, an applicant may be qualified based upon monthly income as stated on the mortgage loan application if the applicant meets certain criteria.

All of these documentation programs require that, with respect to any salaried employee, the applicant s employment be verified by telephone. In the case of a purchase money loan, we require verification of the source of funds, if any, to be deposited by the applicant into escrow. Under each of these programs, we review the applicant s source of income, calculate the amount of income from sources indicated on the loan application or similar documentation, review the applicant s credit history, and calculate the debt service-to-income ratio to determine the applicant s ability to repay the loan. We also review the type, use and condition of the property being financed. We use a qualifying interest rate that is equal to the initial interest rate on the loan to determine the applicant s ability to repay an adjustable-rate loan. For our interest-only adjustable rate mortgage, or ARM, loans we generally use the initial interest-only payment for determining the borrower s repayment ability.

For the year ended December 31, 2005, full documentation loans as a percentage of total originations totaled $30.4 billion, or 54.2%, limited documentation loans totaled $1.5 billion, or 2.7%, and stated documentation loans totaled $24.2 billion, or 43.1%.

Credit History

Our underwriting guidelines require us to obtain a credit report on each applicant from a credit reporting company. In evaluating an applicant s credit history, we utilize credit bureau risk scores, generally known as FICO scores, which are statistical rankings of likely future credit performance reported by the three national credit data repositories Equifax, TransUnion and Experian. We also review all prior mortgage payment histories and public records in addition to the credit report.

The following table reflects the credit grades and FICO scores of our borrowers for the years ended December 31 (dollars in thousands):

	2005				**2004**			
Risk Grades	**Amount**	**%**	**Wtd. Avg. LTV(1) Ratio**	**FICO**	**Amount**	**%**	**Wtd. Avg. LTV(1) Ratio**	**FICO**
AA	$ 42,194,519	75.2	82.5	641	$ 31,990,160	75.8	82.7	642
A +	4,919,909	8.8	79.2	597	4,225,339	10.0	79.6	598
A -	2,626,138	4.7	76.3	574	2,734,814	6.5	76.4	577
B	1,529,765	2.7	73.7	561	1,760,102	4.2	73.9	565
C/ C -	1,291,206	2.3	67.2	556	1,336,108	3.2	68.1	555
Subtotal	52,561,537	93.7	81.3	629	42,046,523	99.7	81.1	627
Commercial Lending	162,912	0.3			135,538	0.3		
Prime and Alt-A	3,383,792	6.0	76.7	713	17,579			
Total	$ 56,108,241	100.0	81.0	634	$ 42,199,640	100.0	81.1	627

(1) Weighted average LTV is the LTV of the first lien mortgages and the combined LTV of the second lien mortgages.

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Geographic Distribution

The following table sets forth by state the aggregate dollar amounts (in thousands) and the percentage of loans we originated or purchased for the periods shown:

	For the Years Ended December 31,					
	2005		2004		2003	
California	$ 20,956,373	37.35%	17,356,938	41.13	11,228,322	41.01
Florida	4,863,876	8.67	2,673,481	6.33	1,653,316	6.04
New York	3,179,280	5.67	2,630,074	6.23	1,632,744	5.96
Arizona	2,228,800	3.97	810,231	1.92	326,349	1.19
New Jersey	2,203,526	3.93	1,484,548	3.52	885,513	3.23
Texas	2,145,907	3.82	1,552,140	3.68	1,135,005	4.15
Illinois	1,841,152	3.28	1,314,726	3.11	1,230,530	4.49
Massachusetts	1,738,268	3.10	1,303,383	3.09	943,160	3.45
Nevada	1,444,757	2.58	1,053,166	2.50	315,799	1.15
Maryland	1,315,028	2.34	843,577	2.00	488,052	1.78
Other	14,191,274	25.29	11,177,376	26.49	7,544,048	27.55
Total	$ 56,108,241	100.00%	42,199,640	100.00	27,382,838	100.00

Financing Loan Originations

We require access to credit facilities in order to originate and purchase mortgage loans and to hold them pending their sale or securitization.

As of December 31, 2005, we used our credit facilities totaling $14.1 billion provided by Bank of America, Barclays Bank, Bear Stearns, Citigroup Global Markets Realty, Credit Suisse First Boston, Deutsche Bank, IXIS Real Estate Capital, Morgan Stanley and UBS Real Estate Securities to finance the funding of our loan originations and purchases. We also fund loans through our $2.0 billion asset-backed commercial paper note facility. We then sell the loans through whole loan sales or securitizations, generally within one to three months, and pay down the financing facilities with the proceeds.

Loan Sales and Securitizations

A majority of the mortgage loans that we originate and sell into the secondary mortgage market are sold through whole loan sales, with a lesser amount sold in the form of securities. For the loans that we retain on our balance sheet, our qualified REIT subsidiaries purchase those loans from New Century Mortgage or Home123, initially using short-term credit facilities. Our qualified REIT subsidiaries then complete CMO securitizations to finance the loans over the long term.

Whole Loan Sales

We sell whole loans on a non-recourse basis pursuant to a purchase agreement in which we give customary representations and warranties regarding the loan characteristics and the origination process. We may be required to repurchase or substitute loans in the event of a breach of these representations and warranties. In addition, we generally commit to repurchase or substitute a loan if a payment default occurs within the first month or two following the date the loan is funded, unless we make other arrangements with the purchaser. The majority of our whole loan sales are sold on a servicing-released basis.

Securitizations

Securitizations Structured as Financings During the year ended December 31, 2005, we completed four securitizations totaling $11.0 billion, which were structured as financings for accounting purposes under Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial

Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125, or SFAS 140. During 2004, we completed five securitizations totaling $10.1 billion, all of which were structured as on-balance sheet securitizations for financial reporting purposes under generally accepted accounting principles. The portfolio-based accounting treatment for securitizations structured as financings and recorded on-balance sheet is designed to more closely match the recognition of income with the receipt of cash payments. Because we do not record gain on sale revenue in the period in which the securitization structured as a financing occurs, the use of such portfolio-based accounting structures results in lower income in the period in which the securitization occurs than would a securitization structured as a sale. However, the recognition of income as interest payments are received on the underlying mortgage loans is expected to result in higher income recognition in future periods than would a securitization structured as a sale.

Securitizations Structured as Sales In a securitization structured as a sale, or off-balance sheet, we sell a pool of loans to a trust for a cash purchase price and a certificate evidencing our residual interest ownership in the trust and the transaction is accounted for as a sale under SFAS 140. The trust raises the cash portion of the purchase price by selling senior certificates representing senior interests in the loans in the trust. Following the securitization, purchasers of senior certificates receive the principal collected, including prepayments, on the loans in the trust. In addition, they receive a portion of the interest on the loans in the trust equal to the specified investor pass-through interest rate on the principal balance. We receive the cash flows from the residual interests after payment of servicing fees, guarantor fees and other trust expenses if the specified over-collateralization requirements are met. Over-collateralization requirements are generally based on a percentage of the original or current unpaid principal balance of the loans and may be increased during the life of the transaction depending upon actual delinquency or loss experience. A net interest margin security, or NIMS, transaction, through which certificates are sold that represent a portion of the spread between the coupon rate on the loans and the investor pass-through rate, may also occur concurrently with or shortly after a securitization. A NIMS transaction allows us to receive a substantial portion of the gain in cash at the closing of the NIMS transaction, rather than over the actual life of the loans.

During 2005, we completed four securitizations structured as sales totaling $6.4 billion. The gain on sale recorded for the four securitizations was $141.5 million and our retained interests totaled $97.5 million. We did not complete any off-balance sheet securitization transactions structured as sales during 2004 or 2003.

In the first quarter of 2004, we invested $2 million in Carrington Capital Management, LLC, or the LLC, and $25 million in Carrington Mortgage Credit Fund I, LP, or Carrington, which is sponsored by the LLC. Carrington acquires individual and pooled single-family residential subprime loans and securitizes them in transactions structured as sales. We were originally the majority investor in Carrington, requiring us to consolidate Carrington s results in our financial statements for financial reporting purposes through September 30, 2004. In the fourth quarter of 2004, Carrington raised additional capital, reducing our ownership position to approximately 38%. Since that time, we have included Carrington in our financial statements under the equity method of accounting. As a result of Carrington s capital raising activities, our ownership position is approximately 7% as of December 31, 2005 and the carrying value of our equity investment in Carrington and the LLC is $39.7 million.

Our Mortgage Loan Portfolio

Our mortgage loan portfolio is comprised of loans originated by us and sold through securitizations structured as financings. Our securitization structure results in ownership interests we retain in what are commonly known as asset-backed securities.

The investment characteristics of our portfolio of asset-backed securities differ from those of traditional fixed-income securities. The major differences include the payment of interest and principal on the asset-backed securities on a more frequent schedule and the possibility that principal may be prepaid at any time due to prepayments on the underlying mortgage loans. These differences can result in significantly greater price and yield volatility than is the case with traditional fixed-income securities.

Various factors affect the rate at which mortgage prepayments occur, including changes in interest rates, general economic conditions, the age of the mortgage loan, the location of the property and other social and

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demographic conditions. Generally, prepayments on asset-backed securities increase during periods of falling mortgage interest rates and decrease during periods of rising mortgage interest rates. As a result, we may replenish the portfolio at a yield that is higher or lower than the yield on the existing portfolio, thus affecting the weighted average yield of our investments.

During 2003, most of our securitizations structured as financings were structured as REMICs as opposed to CMOs. In 2004, most of our securitizations structured as financings were structured as CMOs and in 2005, all of our securitizations structured as financings were structured as CMOs. The CMO structure provides tax efficiencies not available under the REMIC structure.

The following table provides certain information on the mortgage loan portfolio as of December 31, 2005 (dollars in thousands):

	2003 Vintage		2004 Vintage		2005 Vintage	
	REMIC	CMO	REMIC	CMO	REMIC	CMO
Initial collateral pool	$ 3,808,887	1,137,894	1,679,397	8,431,735		10,961,957
Current collateral pool	$ 1,177,971	332,200	1,105,902	4,621,687		8,946,473
Delinquency (60+ days)	5.61%	9.49%	2.41%	4.67%	%	2.42%
Cumulative losses-to-date	0.29%	0.35%	0.02%	0.10%	%	0.01%
Projected cumulative losses over life	1.24%	1.93%	1.52%	2.40%	%	3.05%
Weighted avg. life in years	2.58	2.01	3.25	1.98		2.14

Loan Servicing and Delinquencies

Servicing

Loan servicing activities are designed and implemented to ensure that each loan in a mortgage servicing portfolio is repaid in accordance with its terms. Such activities are generally performed pursuant to servicing contracts we enter into with investors or their agents in connection with whole loan sales or securitizations. The servicing functions performed typically include: collecting and remitting loan payments; making required advances; accounting for principal and interest; customer service; holding escrow or impound funds for payment of taxes and insurance; and, if applicable, contacting delinquent borrowers and supervising foreclosures and property dispositions in the event of un-remedied defaults. For performing these functions for third parties we generally receive a servicing fee of 0.50% annually of the outstanding principal balance of each loan in the mortgage servicing portfolio. The servicing fees are collected from the monthly payments made by the mortgagors. In addition, we generally receive other remuneration consisting of float benefits derived from collecting and remitting mortgage payments, as well as mortgagor-contracted fees such as late fees and, in some cases, prepayment penalties. We use MortgageServ as our main servicing system to perform our servicing activities.

As of December 31, 2005, the balance of our loan servicing portfolio was $39.6 billion, consisting of $15.2 billion in mortgage loans held for investment, $6.7 billion in mortgage loans held for sale, $10.0 billion in mortgage loans sold on a servicing-retained basis, and $7.7 billion in loans serviced on a temporary basis for the purchasers thereof. These loans are serviced through one of our taxable REIT subsidiaries. Approximately $1.0 billion of our mortgage loans held for investment and approximately $1.2 billion of our mortgage loans held for sale are serviced by a third party. Mortgage loans originated through our mortgage loan origination platform acquired from RBC Mortgage through January 2006 were serviced by a third party. We began servicing the majority of these mortgage loans in February 2006.

Servicing Operations

After we originate or purchase a mortgage loan we begin the process of servicing the loan. We originated $56.1 billion in mortgage loans during the year ended December 31, 2005. With the exception of the mortgage loans originated by our mortgage loan origination platform acquired from RBC Mortgage, these loans were

serviced by us on an interim servicing basis prior to sale or were included in one of our securitizations. During the year ended December 31, 2005, we boarded an average of approximately 24,000 new loans per month to our servicing platform and transferred an average of 14,000 loans per month to other unaffiliated servicers pursuant to mortgage loan sales transactions. We expect to continue to retain the servicing rights on a portion of the mortgage loan sold to third parties in whole mortgage loan sales transactions and on all of the mortgage loans that we hold in our portfolio in the future.

During the past two years, we have completed several key servicing platform initiatives. These completed technology initiatives include the deployment of a customer accessible interactive Web site, enhancements to that Web site including payment acceptance, bill presentment and access to key information on payment history, enhancements to the Web site s main servicing system, the implementation of a lockbox payment processing system and deployment of software that improves our loss mitigation activities. In addition, we moved our servicing platform to a new larger facility to allow for increased servicing capacity and growth of our servicing activity.

In the event a borrower becomes delinquent, our loan counselors and mortgage assistant advisors assist the borrower in addressing the reasons for the delinquency, achieving a resolution and bringing the loan current. We will issue a breach of contract notice upon a mortgage loan becoming more than 32 days delinquent unless the applicable state law requires a greater number of actual days of delinquency before permitting the issuance of a breach of contract notice. A breach of contract notice permits the mortgage loan borrower the opportunity to cure the delinquency within the following 30 days before we will initiate a foreclosure action.

Accounts that are referred to our foreclosure department are simultaneously referred to our loss mitigation department. We review and consider a variety of loss mitigation opportunities with the borrower, including the possibility of forbearance agreements, listing the property for sale, using a deed in lieu of foreclosure and full reinstatement of the loan. Loss mitigation strategies are designed to decrease the loss to both the borrower and investor and the resolution of loss mitigation activities are structured to insure, if at all possible, that the loan borrower performs his or her payment obligation in a manner that decreases the prospect of a foreclosure sale, while at the same time minimizing related fees and costs.

In the event that foreclosure is the only resolution available, we engage a local attorney to assure satisfaction of all appropriate legal processes and steps mandated by applicable state and local statutes. Foreclosure timelines are state and locality specific and have been programmed in our primary timeline management software and our loan servicing system. Servicing management responsibility for a mortgage loan property for which the foreclosure sale has been completed and the applicable state redemption period has been exceeded is transferred to our real estate owned department. Our in-house asset managers manage the ultimate disposition of these real estate owned properties with the assistance of local real estate agents. Once a real estate owned property has been vacated and is available for sale, it is listed and marketed for sale. We closely monitor the resulting sales price and overall recovery in order to decrease the loss incurred.

In addition to our written policies and procedures designed to assist our employees in the conduct of servicing activities, we have also adopted servicing best practices that are designed to prevent any unfair or abusive servicing practices. We regularly evaluate our policies and practices to ensure they remain effective and are properly observed.

We intend to continue to retain servicing rights on certain of the loans we sell in future periods. In the second quarter of 2004, we received a rating of RPS3+, or average with noted strengths, from Fitch Ratings for our subprime servicing platform. In 2005, we received a rating of SQ3+, or average, from Moody s Credit Rating Service and, in January 2006, Standard and Poor s upgraded its rating for our subprime servicing platform to above average from average.

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Delinquency Reporting

The following table sets forth loan performance data of the loans on our mortgage loan servicing platform at December 31, 2005 (dollars in thousands):

				Delinquency			
Pool Type	**Balance**	**Weighted Average Coupon**	**FICO**	**<90 days**	**90+**	**Real Estate Owned (REO)**	**Total**
Mortgage loans held for investment(1)	$ 15,150,133	7.04%	629	2.58%	3.29%	0.29%	6.16%
Mortgage loans held for sale(1)	6,670,715	7.97	626	0.74	0.87	0.13	1.74
Interim servicing	7,750,137	7.66	626	0.53	0.25	0.01	0.79
Servicing rights owned	10,039,803	7.22	629	1.44	1.07	0.05	2.56
Total	$ 39,610,788	7.36%	628	1.58%	1.72%	0.15%	3.45%

(1) At December 31, 2005, approximately $1.0 billion of our loans held for investment and $1.2 billion of our mortgage loans held for sale were serviced by a third party.

The following table sets forth loan performance data of the loans on our mortgage loan servicing platform at December 31, 2004 (dollars in thousands):

				Delinquency			
Pool Type	**Balance**	**Weighted Average Coupon**	**FICO**	**<90 days**	**90+**	**Real Estate Owned (REO)**	**Total**
Mortgage loans held for investment(1)	$ 11,573,630	6.92%	631	1.22%	1.04%	0.12%	2.39%
Mortgage loans held for sale	3,884,192	7.01	630	0.20	0.52	0.03	0.75
Interim servicing	7,705,367	7.35	628	0.40	0.01		0.41
Servicing rights owned	1,216,325	7.30	621	1.42	1.44	0.22	3.07
Total	$ 24,379,514	7.09%	629	0.81%	0.65%	0.07%	1.54%

(1) At December 31, 2004, approximately $1.6 billion of our mortgage loans held for investment were serviced by a third party.

Competition

We continue to face intense competition in the business of originating, purchasing and selling mortgage loans. Our competitors include other mortgage banking companies, consumer finance companies, commercial banks, credit

unions, thrift institutions, credit card issuers, insurance finance companies, Internet-based lending companies and other large financial institutions. Large financial institutions may have greater access to capital at a cost lower than our cost of capital under our credit facilities. Federally chartered banks and thrifts have a competitive advantage over us because the federal laws applicable to their operations can preempt some of the state and local lending laws applicable to our operations. Fannie Mae and Freddie Mac presently do not have the legal authority to originate mortgage loans, including subprime loans, but they do have the authority to buy loans. These government-sponsored entities have a size and cost-of-funds advantage that allows them to purchase loans with lower rates or fees than we are willing to offer. Many of these competitors have considerably greater technical and marketing resources than we have. The intense competition in the mortgage industry has led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements.

Competition among industry participants can take many forms, including convenience in obtaining a loan, customer service, marketing and distribution channels, amount and term of the loan, loan origination fees and interest rates. Additional competition may lower the rates we can charge borrowers, thereby potentially

reducing gain on future loan sales and securitizations. Since the majority of our core origination business is conducted through our Wholesale Division, in 2004 and 2005, the most significant form of competition was pricing pressure among wholesale mortgage originators. Some of our competitors lowered rates and fees to preserve or expand their market share. Competition typically becomes increasingly intense in a rising interest rate environment, when mortgage lenders do not necessarily increase their coupon rates as quickly as short-term interest rates are increasing. During these periods, profit margins generally decline.

Our results of operations, financial condition and business prospects could be harmed if competition intensifies or if any of our competitors significantly expands its activities in our markets.

Regulation

Our mortgage banking business is subject to the rules, regulations or guidelines of, and/or examination by, the following entities with respect to the processing, originating, selling and servicing of mortgage loans:

- State regulatory authorities;
- The Department of Housing and Urban Development, or HUD;
- The Federal Housing Administration, or the FHA;
- The Department of Veteran Affairs, or the VA;
- Fannie Mae, Freddie Mac and Ginnie Mae; and
- The Federal Home Loan Bank, or the FHLB.

The rules, regulations and requirements of these entities, among other things, impose licensing obligations on us and our subsidiaries, establish standards for processing, underwriting and servicing mortgage loans, prohibit discrimination, restrict certain loan features in some cases, and fix maximum interest rates and fees.

Our business activities are also subject to examination by the Federal Housing Commissioner to assure compliance with FHA regulations, policies and procedures. As an FHA lender, we are required to submit to the FHA Commissioner on an annual basis audited financial statements. In addition, Ginnie Mae, HUD, Fannie Mae and Freddie Mac require the maintenance of specified net worth levels (which vary among the entities).

We are subject to judicial and administrative decisions that impose requirements and restrictions on our business. Mortgage origination activities are regulated by federal, state and local government authorities and are subject to extensive federal, state and local laws, rules and regulations. At the federal-level, these laws and regulations include the:

- Equal Credit Opportunity Act;
- Federal Truth in Lending Act and Regulation Z;
- Home Ownership and Equity Protection Act;
- Real Estate Settlement Procedures Act and Regulation X;
- Fair Credit Reporting Act;
- Fair Debt Collection Practices Act;
- Home Mortgage Disclosure Act;
- Fair Housing Act;

Telephone Consumer Protection Act;

Gramm-Leach-Bliley Act;

Fair and Accurate Credit Transactions Act;

- CAN-SPAM Act;
- Sarbanes-Oxley Act; and
- USA PATRIOT Act.

These laws, rules and regulations, among other things:

- impose licensing obligations and financial requirements on us;
- limit the interest rates, finance charges and other fees that we may charge;
- prohibit discrimination;
- impose underwriting requirements;
- mandate disclosures and notices to consumers;
- mandate the collection and reporting of statistical data regarding our customers;
- regulate our marketing techniques and practices;
- require us to safeguard non-public personal information about our customers;
- regulate our collection practices;
- require us to prevent money-laundering or the conduct of business with suspected terrorists; and
- impose corporate governance, internal control and financial reporting obligations and standards.

Our failure to comply with these laws can lead to:

- civil and criminal liability;
- loss of approved status;
- demands for indemnification or loan repurchases from buyers of our loans;
- class action lawsuits; and
- administrative enforcement actions.

Compliance, Quality Control and Quality Assurance

We regularly monitor the laws, rules and regulations that apply to our business and analyze any changes to them. We integrate many legal and regulatory requirements into our automated loan origination system to reduce the prospect of inadvertent non-compliance due to human error. We also maintain policies and procedures, summaries and checklists to help our origination personnel comply with these laws.

Our training programs are designed to teach our personnel about the significant laws, rules and regulations that affect their job responsibilities. We also maintain a variety of pre-funding quality control procedures designed to detect compliance errors prior to funding.

In addition, we also subject a statistically valid sampling of our loans to post-funding quality assurance reviews and analysis. We track the results of the quality assurance reviews and report them back to the responsible origination units. To the extent refunds or other corrective actions are appropriate, we deduct those amounts from the internal profit and loss calculation for that origination unit.

Our loans and practices are also reviewed regularly in connection with the due diligence that our loan buyers and lenders perform. Our state regulators also review our practices and loan files regularly and report the results back to us. Since our inception, we have undergone over 140 state examinations, which have never resulted in findings of material violations or penalties.

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Licensing

As of December 31, 2005, two of our taxable REIT subsidiaries were licensed or exempt from licensing requirements by the relevant state banking or consumer credit agencies to originate first and second mortgages in all 50 states and the District of Columbia. As of December 31, 2005, one of our qualified REIT subsidiaries was authorized to originate mortgage loans in 45 states and we are seeking to license that qualified REIT subsidiary in the states in which it is not currently authorized to originate mortgages.

Regulatory Developments

During 2005, federal and state legislators and regulators adopted a variety of new or expanded regulations, particularly in the areas of privacy and consumer protection. These regulations are summarized below.

Privacy and Data Security

The federal Gramm-Leach-Bliley financial reform legislation imposes additional obligations on us to safeguard the information we maintain on our borrowers. Regulations have been promulgated and continue to be proposed by several agencies that may affect our obligations to safeguard information. In addition, several federal agencies are considering regulations that could affect the content of our notices. Also, several states are considering even more stringent privacy legislation. California has passed two pieces of legislation known as the California Financial Information Privacy Act and the California On-Line Privacy Protection Act. Both pieces of legislation became effective July 1, 2004, and impose additional notification obligations on us that are not pre-empted by existing federal law. In addition, California s Shine the Light Law, effective January 1, 2005, imposes additional requirements on businesses to disclose to customers how their personal information is shared, and the California Information Safeguard Law AB1950 imposes the obligation on businesses to establish procedural and electronic safeguards to protect customer personal information. If other states choose to follow California and adopt a variety of inconsistent state privacy legislation, our compliance costs could substantially increase.

In 2005, in response to the many well publicized incidents involving the breach of consumer personal confidential data, a number of states enacted laws that govern our duty to notify customers and consumers in the event there is a breach of their personal confidential information as defined in those laws. Failure to provide proper and timely notification following a breach could result in fines and penalties being imposed, which, in some cases, can be criminal in nature as well as potentially subject us to legal actions for damages both compensatory and punitive. Also, there are currently pending in Congress, 23 proposed bills dealing with data security and data breach notification. Some of these new laws would pre-empt state law if enacted and create a uniform national standard, but others would create a federal standard that could be superseded by stricter state laws. These laws have and will continue to impose regulatory and compliance costs on us.

Fair Credit Reporting Act

The Fair Credit Reporting Act provides federal preemption for lenders to share information with affiliates and certain third parties and to provide pre-approved offers of credit to consumers. Changes to the Fair Credit Reporting Act were made in December 2003, and some provisions will not become effective until the federal regulatory agencies issue final regulations. These new provisions impose additional regulatory and compliance costs on us and reduce the effectiveness of our marketing programs.

Home Mortgage Disclosure Act

In 2002, the Federal Reserve Board adopted changes to Regulation C promulgated under the Home Mortgage Disclosure Act. Among other things, the new regulations require lenders to report pricing data on loans with annual percentage rates that exceed the yield on treasury bills with comparable maturities by 3%. The expanded reporting took effect in 2004 for reports filed in 2005. As anticipated, a significant portion of our loans were subject to the expanded reporting requirements.

The expanded reporting does not provide for additional loan information such as credit risk, debt-to-income ratio, LTV, documentation-level or other salient loan features. As a result, lenders are concerned that the reported information may lead to increased litigation as the information could be misinterpreted by third parties.

Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003

The CAN-SPAM Act of 2003 took effect on January 1, 2004 and applies to businesses, such as ours, that use electronic mail for advertising and solicitation. This law, generally administered by the Federal Trade Commission, preempts state laws to the contrary, and establishes, among other things, a national uniform standard that gives recipients of e-mail messages principally promoting a good or service the right to stop unwanted emails. New requirements include: truthful and accurate header captions in emails as well as return email addresses; specifying a valid physical postal address of the sender; notifying consumers of the right to opt out from receiving further emails from the sender and providing an opt out mechanism and timely honoring an opt out request. Effective March 28, 2005, new rules apply to dual-purpose e-mails where a commercial message is included with transactional or relationship e-mail. These new and existing provisions impose additional regulatory and compliance costs on us and potentially reduce the effectiveness of our marketing programs.

Telephone Consumer Protection Act and Telemarketing Consumer Fraud and Abuse Prevention Act

The Telephone Consumer Protection Act and the Telemarketing Consumer Fraud and Abuse Prevention Act, enacted in 1991 and 1994, respectively, are designed to restrict unsolicited advertising using the telephone and facsimile machine. Since they were enacted, however, telemarketing practices have changed significantly due to new technologies that make it easier to target potential customers while at the same time making it more cost effective to do so. The Federal Communications Commission, or the FCC, and the Federal Trade Commission, or the FTC, have responsibility for regulating various aspects of these laws, such as regulating unwanted telephone solicitations and the use of automated telephone dialing systems, prerecorded or artificial voice messages and telephone facsimile machines. In 2003, both agencies adopted a national do-not-call registry requirement, which, in part, mandated that companies such as us (i) cross reference our prospective telemarketing lists against the national do-not-call registry to avoid contacting enrolled customers unless established exceptions apply, (ii) regularly check the do-not-call registry for updates at least every 31 days, and (iii) maintain and regularly update an internal company list comprised of consumers who have chosen not to be called or receive facsimile advertising specifically from us. Over 25 states have also adopted similar laws, with which we also comply. As with other regulatory requirements, these provisions impose additional regulatory and compliance costs on us and reduce the effectiveness of our marketing programs.

Predatory Lending Legislation

The Home Ownership and Equity Protection Act of 1994, or HOEPA, identifies a category of mortgage loans and subjects them to more stringent restrictions and disclosure requirements. In addition, liability for violations of applicable law for loans covered by HOEPA extends not only to the originator but also to the purchaser of the loans. HOEPA generally covers loans with either (i) total points and fees upon origination in excess of the greater of eight percent of the loan amount or $528 (an annually adjusted dollar amount), or (ii) an APR of more than eight percentage points higher than United States Treasury securities, or Treasuries, of comparable maturity on first mortgage loans and 10 percentage points above Treasuries of comparable maturity for junior mortgage loans.

We do not originate loans covered by HOEPA because of the higher legal risks as well as the potential negative perception of originating loans that are considered to be high cost under federal law. Several federal, state and local laws and regulations have been adopted or are under consideration that are intended to eliminate so-called predatory lending practices. Many of these laws and regulations go beyond targeting abusive practices by imposing broad restrictions on certain commonly accepted lending practices, including some of our practices. In addition, some of these laws impose liability on assignees of mortgage loans such as

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loan buyers, lenders and securitization trusts. Such provisions deter loan buyers from purchasing loans covered by the applicable law.

In 2005, we continued to be subject to adverse state legislation. For example, Illinois enacted House Bill 4050 (HB 4050) in 2005, which will subject certain zip codes in Cook County, Illinois to a pilot program that potentially may have larger statewide implications for our subprime business. Under the terms of HB 4050, the law requires brokers, lenders, title companies, closing agents and credit counselors to report detailed borrower loan information for loans being made to borrowers within the designated zip codes in Cook County. Pursuant to regulations promulgated by the Department of Financial and Professional Regulation, or the DFPR, the DFPR determines which borrowers must receive loan counseling in an effort to avoid abusive or predatory loan terms. The brokers or lenders are required to pay for the loan counseling and the loan may not be closed until the borrower completes loan counseling. The law was to become effective January 1, 2006, but its effective date has been postponed until a secure database for the borrower information being gathered can be created and the logistics of how loan counseling will be handled can be worked out. It is anticipated that the law will become effective in the spring of 2006, unless a legal challenge is mounted. Further clarifying regulations are to be issued and we will be studying them to see what impact the law and the regulations will have on our ability to do business in these zip codes.

Additionally, we await judicial decisions in two court cases, either one of which may have significant impact on our lending operations. In Ohio, the issue awaiting decision by the Ohio Supreme Court in the case of *American Financial Services Association vs. The City of Cleveland* is whether or not cities and counties in Ohio have the right to enact predatory lending ordinances even though state legislation specifically preempts their ability to do so. An adverse decision will subject us to a myriad of local lending laws. In Montgomery County, Maryland, in the case of *American Financial Services Association, et al vs. Montgomery County, Maryland,* a trial court has enjoined a local predatory lending/discrimination ordinance from taking effect, pending a full hearing as to whether or not it is preempted by Maryland state law.

These decisions and new laws impose additional regulatory and compliance costs on us and reduce the effectiveness of our marketing programs. There can be no assurance that other similar laws, rules or regulations will not be adopted in the future. Adoption of these laws and regulations could have a material adverse impact on our business by substantially increasing the costs of compliance with a variety of inconsistent federal, state and local rules, or by restricting our ability to charge rates and fees adequate to compensate us for the risk associated with certain loans. Adoption of these laws could also have a material adverse effect on our loan origination volume, especially if our lenders and secondary market buyers elect not to finance or purchase loans covered by the new laws. We remain in favor of strong uniform national standards and are supporting legislative initiatives consistent with this principle.

Efforts to Avoid Abusive Lending Practices

In an effort to prevent the origination of loans containing unfair terms or involving predatory practices, we have adopted many policies and procedures, including the following.

Product Policies

We do not fund or purchase high cost loans as defined by HOEPA.

We do not make or purchase loans containing single premium credit life, disability or accident insurance.

We do not make or purchase loans containing mandatory arbitration clauses or interest rate increases triggered by borrower default. None of the subprime loans we make or purchase allow for negative amortization of the loan.

We offer loans with and without prepayment penalties. When a borrower opts for a loan with a prepayment charge, the borrower benefits from a lower interest rate and/or pays lower upfront fees.

Our prepayment penalties do not extend beyond three years from the origination date. On fixed rate loans, the maximum prepayment penalty term is three years. Prepayment penalties on adjustable rate subprime loans do not extend beyond the first adjustment date.

We do not originate loans that pay off zero interest rate mortgages provided by charitable organizations or the government without borrower third-party counseling.

Loan Processing Policies

We only approve subprime loan applications that evidence a borrower s ability to repay the loan.

We consider whether a subprime borrower s loan terms are in the borrower s best interests and document our belief that the loan represents a tangible benefit to the borrower. We are currently working to set up a similar system for loans originated through our mortgage origination platform acquired from RBC Mortgage.

We do not resolicit our borrowers within 12 months of loan origination.

We price loans commensurate with risk.

We use an electronic credit grading system for our subprime loans to help ensure consistency of grading.

We do not ask appraisers to report a predetermined value or withhold disclosure of adverse features.

We employ electronic and manual systems to protect against adverse practices like property flipping. Loan origination systems are designed to detect red flags such as inflated appraisal values, unusual multiple borrower activity or rapid loan turnover.

Customer Interaction and Education

We market our loans with a view to encouraging a wide range of applicants strongly representative of racial, ethnic and economic diversity in the markets we serve throughout the nation.

We provide a helpful, easy-to-follow brochure to all our loan applicants to educate them on the loan origination process, explain basic loan terms, help them obtain a loan that suits their needs and advise them on how to find a U.S Department of Housing and Urban Development, or HUD-approved loan counselor.

We distribute our Fair Lending Policy to all newly hired employees and hold them accountable for treating borrowers fairly and equally.

We provide fair lending training to employees having direct contact with borrowers or loan decision-making authority.

We require brokers to sign an agreement indicating that they are knowledgeable about and will abide by fair lending laws and our Broker Code of Conduct.

We monitor broker performance and strive to hold brokers accountable for fair and equal treatment of borrowers.

Our Retail Division conducts regular customer satisfaction surveys of all newly funded loans.

We also conduct periodic randomly selected satisfaction surveys of customers who receive loans through a mortgage broker.

Each division is supported by well-trained consumer relations staff dedicated to resolving consumer complaints in a timely and fair manner.

Our Loan Servicing Department contacts each borrower prior to the first payment to confirm that the borrower understands the loan payment terms.

When appropriate, we also offer loss mitigation counseling to borrowers in default and provide opportunities to enter into mutually acceptable reasonable repayment plans.

We report borrower monthly payment performance to major credit repositories.

Evaluation and Compliance

We subject a significant statistical sampling of our loans to a quality assurance review of borrower qualification, validity of information and verified property value determination.

Our Fair Lending Officer provides an independent means of reporting or discussing fair lending concerns through consumer and employee hotlines.

Our Fair Lending Officer monitors production of fair lending performance, including loan file analysis and reporting, and coordinates community outreach programs.

We periodically engage independent firms to review internal controls and operations to help ensure compliance with accepted federal and state lending regulations and practices.

We adhere to high origination standards in order to sell our loan products in the secondary mortgage market.

We treat all customer information as confidential and consider it to be nonpublic information. We maintain systems and procedures designed to ensure that access to nonpublic consumer information is granted only to legitimate and valid users.

We use sophisticated fraud prevention and detection applications and techniques that allow us to better protect our customers from fraud and identity theft.

We believe that our commitment to responsible lending is good business.

We strive to promote highly ethical standards throughout our industry.

We plan to continue to review, revise and improve our practices to enhance our fair lending efforts and support the goal of eliminating predatory lending practices in the industry. Our policies and procedures are subject to change from time to time and without notice.

Environmental

In the course of our business, we may acquire properties securing loans that are in default. There is a risk that hazardous or toxic waste could be found on such properties. If this occurs, we could be held responsible under applicable law for the cost of cleaning up or removing the hazardous waste. This cost could exceed the value of the underlying properties.

Employees

As of December 31, 2005, we employed approximately 7,200 employees. None of our employees are subject to a collective bargaining agreement. We believe that our relations with our employees are satisfactory.

Available Information

We make available, free of charge, on the Investor Relations Section of our Web site (http://investorrelations.ncen.com/), our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Section 16 reports and any amendments to those reports as soon as reasonably practicable after such reports or amendments are electronically filed with or furnished to the SEC.

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MATERIAL U.S. FEDERAL INCOME TAX CONSIDERATIONS

Introduction

The following general discussion summarizes the material U.S. federal income tax considerations regarding our qualification and taxation as a REIT. This discussion is based on interpretations of the Code, regulations issued thereunder, and rulings and decisions currently in effect (or in some cases proposed), all of which are subject to change. Any such change may be applied retroactively and may adversely affect the federal income tax consequences described herein. This summary does not discuss all of the tax consequences that may be relevant to particular stockholders or stockholders subject to special treatment under the federal income tax laws. Accordingly, you should consult your own tax advisor regarding the federal, state, local, foreign, and other tax consequences of your ownership and our REIT election, and regarding potential changes in applicable tax laws.

In general, the Code does not differentiate between preferred and common stockholders when applying the tax laws to stockholders. Unless specifically indicated otherwise, all references to stockholders shall include both our common and preferred classes of stock.

Taxation as a REIT

Generally. We have elected to be taxed as a REIT under Sections 856 through 859 of the Code commencing with our taxable year ended December 31, 2004. To qualify as a REIT, we must meet a number of organizational and operational requirements, including a requirement that we distribute currently to our stockholders at least 90% of our REIT taxable income. As a REIT, we generally are not subject to federal corporate income tax on that portion of our REIT taxable income that we distribute currently to our stockholders. Even if we qualify as a REIT, however, we may be subject to tax in certain situations. In addition, any taxable REIT subsidiary or TRS in which we own an interest, including New Century TRS Holdings, Inc. and its subsidiaries, is subject to federal corporate income tax on its taxable income at the highest applicable state and federal corporate tax rates.

There are no differences in the taxation of our common and preferred shares. All stockholders will generally be taxed on the dividends they receive at ordinary income rates unless such dividends are designated by us as a capital gain dividend or as qualified dividend income. Since our conversion to a REIT, all dividends paid are taxed at ordinary income rates. We urge all investors to consult their own independent tax advisors regarding the effect of all tax matters, including federal, state, local and in the case of non U.S. investors, international tax laws, for their investment in New Century common or preferred stock.

Many of the requirements for qualification as a REIT are highly technical and complex and require an analysis of factual matters and an application of the legal requirements to such factual matters in situations where there is only limited judicial and administrative guidance. Therefore, no assurance can be given that we have qualified or will qualify as a REIT for any particular year. If we fail to qualify as a REIT in any taxable year, we will be subject to federal income tax at regular corporate rates and may not be able to qualify as a REIT for four subsequent tax years. Failure to qualify as a REIT would adversely affect our net income, our dividend distributions and could adversely affect the value of our stock.

Taxable Income. We use the calendar year for both tax and financial reporting purposes. However, there may be differences between taxable income, taxable REIT income, and income computed in accordance with accounting principles generally accepted in the United States of America (GAAP). These differences primarily arise from permanent differences created by taxable intercompany transactions between TRS and REIT level companies or to the timing and character differences in the recognition of revenue and expense and gains and losses for tax and GAAP purposes. Additionally, taxable REIT income does not include the taxable income of our taxable REIT subsidiaries, although the TRS operating results are included in our GAAP results.

Taxable mortgage pools and REMICs. We will make investments or enter into financing and securitization transactions that give rise to our being considered to be, or to own an interest in, one or more

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taxable mortgage pools or REMICs, although we do not intend to engage in REMIC securitization transactions other than through one of our Taxable REIT Subsidiaries.

Under the REIT rules, any portion of our income from a REMIC residual interest or taxable mortgage pool, including non-cash accrued income, or phantom taxable income that is owned by the REIT, will be treated as excess inclusion income and the character of that income will be passed along to our stockholders via the dividend each quarter.

The amount of excess inclusion income in any given year from these activities, transactions and investments by the REIT could be significant. Generally, individuals and taxable corporations investing in New Century and receiving our dividends will not be required to report or consider excess inclusion income when they file their annual tax return unless they fall into one of the three special tax circumstances listed below.

1. That portion of our dividend represented by excess inclusion income may not be offset by any net operating losses otherwise available to the stockholder.

2. Stockholders otherwise generally exempt from federal income tax as a non-profit organization will, for that portion of our dividend represented by excess inclusion income, be subject to tax for unrelated business taxable income or UBTI.

3. For most types of foreign stockholders that portion of our dividend represented by excess inclusion income will result in the application of U.S. federal income tax withholding at the maximum rate (i.e., 30%), without reduction for any otherwise applicable income tax treaty.

The Treasury Department has yet to issue regulations governing the exact computation of excess inclusion income, its reporting and finally the tax treatment of the stockholders of a REIT that owns an interest in a taxable mortgage pool. Accordingly, the manner in which excess inclusion income is to be allocated among shares of different classes of our stock or how such income is to be reported to our stockholders is not clear under current law. Tax-exempt investors, foreign investors, and taxpayers with net operating losses should carefully consider the tax consequences described above and are urged to consult their tax advisors in connection with their decision to invest in our stock.

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EXECUTIVE OFFICERS OF THE REGISTRANT

The following table sets forth information about our executive officers as of March 1, 2006:

Name	Age	Position
Executive Officers:		
Robert K. Cole	59	Chairman of the Board of Directors and Chief Executive Officer of New Century
Brad A. Morrice	49	Vice Chairman of the Board of Directors, President and Chief Operating Officer of New Century; Chief Executive Officer and Director of New Century Mortgage(1); Chairman of the Board of Directors and Chief Executive Officer of NC Capital(2); Chairman of the Board of Directors and Chief Executive Officer of Home123(3)
Edward F. Gotschall	51	Vice Chairman-Finance of the Board of Directors of New Century; Chief Financial Officer and Director of NC Capital
Patrick J. Flanagan	40	Executive Vice President of New Century
Kevin M. Cloyd	35	Executive Vice President of New Century and Home123; Executive Vice President and Director of New Century Mortgage; President and Director of NC Capital
Patti M. Dodge	45	Executive Vice President and Chief Financial Officer of New Century and New Century Mortgage; Chief Financial Officer and Director of Home123
Stergios Theologides	39	Executive Vice President-Corporate Affairs and General Counsel of New Century; Executive Vice President-Corporate Affairs, Senior Legal Counsel and Secretary of New Century Mortgage; Executive Vice President and Director of NC Capital; Corporate Secretary of Home123
Joseph F. Eckroth, Jr.	47	Executive Vice President of New Century and Executive Vice President, Chief Information Officer and Chief Operating Officer of New Century Mortgage

(1) New Century Mortgage is a wholly owned direct subsidiary of New Century TRS.

(2) NC Capital is a wholly owned direct subsidiary of New Century Mortgage.

(3) Home123 is a wholly owned indirect subsidiary of New Century TRS.

Robert K. Cole, one of our co-founders, has been the Chairman of our board of directors and Chief Executive Officer since December 1995 and one of our directors since November 1995. Mr. Cole also served as a director of New Century Mortgage from November 1995 to April 2005. From February 1994 to March 1995, he was the President and Chief Operating Officer-Finance of Plaza Home Mortgage Corporation, a publicly-traded savings and loan holding company specializing in the origination and servicing of residential mortgage loans. In addition, Mr. Cole served as a director of Option One Mortgage Corporation, a subsidiary of Plaza Home Mortgage specializing

in the origination, sale and servicing of non-prime mortgage loans. Previously, Mr. Cole was the President of operating subsidiaries of NBD Bancorp and Public Storage, Inc. Mr. Cole received a Masters of Business Administration degree from Wayne State University.

Brad A. Morrice, one of our co-founders, has been a Vice Chairman of our board of directors since December 1996, our President and one of our directors since 1995, and our Chief Operating Officer since January 2001. Mr. Morrice also served as our General Counsel from December 1995 to December 1997 and our Secretary from December 1995 to May 1999. In addition, Mr. Morrice serves as Chief Executive Officer and a director of New Century Mortgage and Chairman of the board of directors and Chief Executive Officer of NC Capital and Home123. From February 1994 to March 1995, he was the President and Chief Operating Officer-Administration of Plaza Home Mortgage, after serving as its Executive Vice President, Chief Administrative Officer since February 1993. In addition, Mr. Morrice served as General Counsel and a director of Option One. From August 1990 to January 1993, Mr. Morrice was a partner in the law firm of King, Purtich & Morrice, where he specialized in the legal representation of mortgage banking companies. Mr. Morrice previously practiced law at the firms of Fried, King, Holmes & August and Manatt, Phelps & Phillips. He received his law degree from the University of California, Berkeley (Boalt Hall) and a Masters of Business Administration degree from Stanford University.

Edward F. Gotschall, one of our co-founders, has been the Vice Chairman-Finance of our board of directors since July 2004, a Vice Chairman of our board of directors since December 1996 and one of our directors since November 1995. Prior to being appointed Vice Chairman-Finance, Mr. Gotschall served as our Chief Financial Officer from August 1998 to July 2004 and our Chief Operating Officer Finance/ Administration from December 1995 to August 1998. Mr. Gotschall also served as a director of New Century Mortgage from August 1995 to April 2005 and was its Executive Vice President from December 1995 to March 2004 and its Chief Financial Officer from August 1995 to February 2002. Mr. Gotschall is also Chief Financial Officer and a director of NC Capital. From April 1994 to July 1995, he was the Executive Vice President/ Chief Financial Officer of Plaza Home Mortgage and a director of Option One. Mr. Gotschall was one of the co-founders of Option One and from December 1992 to April 1994, Mr. Gotschall served as its Executive Vice President/ Chief Financial Officer. From January 1991 to July 1992, he was the Executive Vice President/ Chief Financial Officer of The Mortgage Network, Inc., a retail mortgage banking company. Mr. Gotschall received his Bachelors of Science in Business Administration degree from Arizona State University.

Patrick J. Flanagan has been our Executive Vice President since August 1998. Mr. Flanagan entered into an employment agreement with us on December 27, 2005 whereby he commenced a leave of absence January 1, 2006 and his term as our Executive Vice President will expire as of the earlier to occur of June 30, 2006 or Mr. Flanagan s termination of employment with us. Upon expiration of Mr. Flanagan s term as Executive Vice President on July 1, 2006, the consulting agreement he entered with us on December 27, 2005 will become effective, subject to certain conditions. Mr. Flanagan was the President of New Century Mortgage from February 2002 to February 2006 and a director of New Century Mortgage from May 1997 to February 2006. Mr. Flanagan was also the Chief Executive Officer and a director of NC Capital until February 2006. From January 1997 to February 2002, Mr. Flanagan served as Executive Vice President and Chief Operating Officer of New Century Mortgage. Mr. Flanagan initially joined New Century Mortgage in May 1996 as Regional Vice President of Midwest Wholesale and Retail Operations. From August 1994 to April 1996, Mr. Flanagan was a Regional Manager with Long Beach Mortgage. From July 1992 to July 1994, he was an Assistant Vice President for First Chicago Bank, from February 1989 to February 1991, he was Assistant Vice President for Banc One in Chicago, and from February 1991 to July 1992, he was a Business Development Manager for Transamerica Financial Services. Mr. Flanagan received his Bachelor of Arts degree from Monmouth College.

Kevin M. Cloyd has been our Executive Vice President since March 2004. He has been the President of NC Capital since February 2002 and one of its directors since December 2002. Mr. Cloyd has also served as Executive Vice President of New Century Mortgage since March 2004 and one of its directors since February 2006 and as Executive Vice President of Home123 since August 2005. Mr. Cloyd previously served as Senior Vice President of Secondary Marketing for New Century Mortgage from February 2002 to March 2004, and as Vice President of Secondary Marketing for New Century Mortgage and Executive Vice President of NC Capital from January 2001 to February 2002. From March 2000 to January 2001, Mr. Cloyd left New Century Mortgage to become the Vice President in charge of Secondary Marketing and Finance for The Mortgage

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Conduit, a start-up company. Mr. Cloyd initially joined New Century Mortgage in September 1999 as Vice President of Applied Analytics. From December 1998 to September 1999, Mr. Cloyd was Assistant Vice President with Fremont Investment and Loan. Prior to Fremont Investment and Loan, from April 1996 to December 1998, Mr. Cloyd served as Director of Finance with Amresco Residential Credit Corporation and was responsible for Pricing and Analytics. In addition, from 1994 to April 1996, Mr. Cloyd worked at Bank of America Mortgage and served as Financial Consultant to their Secondary Marketing and Portfolio Management Departments. Mr. Cloyd received his Bachelor of Arts degree in Business Administration with an emphasis in Finance from California State University at Fullerton. Mr. Cloyd received his Masters of Arts in Management from the University of Redlands.

Patti M. Dodge has been our Chief Financial Officer since July 2004 and our Executive Vice President since March 2004. Ms. Dodge previously served as our Controller from September 1996 to July 2005 and our Senior Vice President from September 1996 to March 2004. Ms. Dodge has also served as the Executive Vice President and Chief Financial Officer of New Century Mortgage since March 2004 and served as the Senior Vice President and Chief Financial Officer of New Century Mortgage between February 2002 and March 2004. In addition, Ms. Dodge has served as the Chief Financial Officer of Home123 since March 2004 and one its directors since February 2006. Prior to joining us, Ms. Dodge was self-employed. From December 1990 to June 1995, Ms. Dodge was Senior Vice President at Plaza Home Mortgage Corporation. From February 1989 to December 1990, Ms. Dodge served as Vice President and Chief Financial Officer of University Savings Bank and from October 1984 to February 1989, Ms. Dodge served as Controller of Butterfield Savings. Ms. Dodge received her Bachelor s in Business Administration degree with an emphasis in accounting from the University of Southern California.

Stergios Theologides has been our Executive Vice President-Corporate Affairs since March 2003, and has served as General Counsel since April 1998. Mr. Theologides also served as our Corporate Secretary from May 1999 to May 2005. Mr. Theologides is responsible for all of our legal, regulatory affairs and compliance matters. Mr. Theologides joined us in April 1998 as Vice President and General Counsel. Mr. Theologides also serves as Executive Vice President Corporate Affairs, Senior Legal Counsel and Secretary of New Century Mortgage and Executive Vice President and Director of NC Capital. In addition, Mr. Theologides has served as Corporate Secretary of Home123 since March 2004. Previously, Mr. Theologides had been employed with Wynn s International, Inc. from February 1996 to March 1998 where he served as Corporate Counsel. Mr. Theologides was an associate in the corporate department of O Melveny & Myers, LLP, from 1992 to 1996. Mr. Theologides received his Juris Doctorate from Columbia University School of Law where he was a Harlan Fiske Stone Scholar and Charles Evans Hughes Fellow. He received his Bachelor of Arts degree from Princeton University with his major in public and international affairs.

Joseph F. Eckroth, Jr. joined us as Senior Vice President and Chief Information Officer in July 2005. In January 2006, Mr. Eckroth was promoted to Executive Vice President and Chief Operating Officer of New Century Mortgage Corporation and in March 2006 Mr. Eckroth was promoted to Executive Vice President of New Century Financial Corporation. Prior to joining us, Mr. Eckroth was the Chief Information Officer for Mattel, Inc., the world s largest toy manufacturer, a position he held from 2000 to 2005. From 1996 to 2000, Mr. Eckroth served as an information technology executive for the General Electric Company, where he held the position of Chief Information Officer for the GE Medical Systems and GE Industrial Systems business units. From 1985 to 1996, Mr. Eckroth served in a variety of executive operations, quality assurance and technology positions for the Northrop Grumman Corporation. Mr. Eckroth received his Masters of Business Administration degree from Pepperdine University School of Business and Management. He also serves on the Board of Directors for VWR International, a scientific and medical supplies distribution company, a position he has held since November 2004.

Item 1A. ***Risk Factors***

Stockholders and prospective purchasers of our common stock should carefully consider the risks described below before making a decision to buy our common stock. If any of the following risks actually occurs, our business could be harmed. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment. When determining whether to buy our common stock,

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stockholders and prospective purchasers should also refer to the other information in this annual report on Form 10-K, including our financial statements and the related notes.

Risks Related to Our Business

We are dependent on external sources of financing, and if we are unable to maintain adequate financing sources, our earnings and our financial position will suffer and jeopardize our ability to continue operations.

We require substantial cash to support our operating activities and growth plans in our taxable REIT subsidiaries. Our primary sources of cash for our mortgage loan origination activities are our warehouse and aggregation credit facilities, our asset-backed commercial paper facility and the proceeds from the sales and securitizations of our mortgage loans. As of December 31, 2005, we had twelve short-term warehouse and aggregation credit facilities and our asset-backed commercial paper facility that provided us with approximately $13.1 billion of committed and $3.0 billion of uncommitted borrowing capacity to fund mortgage loan originations and purchases pending the pooling and sale of such mortgage loans. From time to time, we finance our residual interests in securitization transactions through the sale of net interest margin securities, or NIMS. During volatile times in the capital and secondary markets, access to warehouse, aggregation and NIMS financing as well as to the securitization and secondary markets for the sale of our mortgage loans has been severely constricted. If we cannot maintain or replace these facilities on comparable terms and conditions, we may incur substantially higher interest expense that would reduce our profitability.

We also require substantial cash in order for our REIT to purchase and hold mortgage loans through securitizations structured as financings and to engage in hedging transactions. Our sources of cash for purchasing mortgage loans to be held for investment are the capital markets, borrowings from our taxable REIT subsidiaries or releases of over-collateralization accounts from prior securitizations structured as financings. If we have inadequate cash at the REIT, we may not be able to grow or maintain our REIT portfolio size, which may harm our ability to maintain or grow our REIT dividend. Likewise, a large margin call on our hedging instruments could negatively affect our liquidity position.

In addition, we require substantial cash to pay our required REIT dividends. To qualify as a REIT under the Code, we generally are required each year to distribute to our stockholders at least 90% of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding net capital gains). After-tax earnings generated by our taxable REIT subsidiaries and not distributed to us are not subject to these distribution requirements and may be retained by such subsidiaries to provide for future growth, subject to the limitations imposed by REIT tax rules. We conduct a substantial amount of our business through our taxable REIT subsidiaries. We cannot be certain that we will have access to funds to meet the REIT distribution and other qualification requirements. We may be required to borrow funds from one of our corporate subsidiaries or a third party on a short-term basis or liquidate investments to meet the distribution requirements that are necessary to qualify as a REIT, even if management believes that it is not in our best interests to do so. If we do not have access to the necessary funds, we may have to raise capital at inopportune times or borrow funds on unfavorable terms. However, if we are unable to maintain adequate financing or other sources of capital are not available, we would be forced to suspend or curtail our operations, which would harm our results of operations, financial condition and business prospects. Similarly, we may be required to pursue one or more alternative strategies, such as selling assets, refinancing or restructuring our indebtedness or selling additional debt or equity securities.

We face intense competition that could harm our market share and our revenues.

We face intense competition from finance and mortgage banking companies, Internet-based lending companies and large financial institutions.

Over the past year, we have experienced severe pricing competition from lenders who are offering interest rates lower than those we charge. Currently, we do not intend to compete solely on the basis of loan pricing. If the other features of our mortgage loans do not provide enough advantages to induce our potential wholesale

and retail customers to choose our mortgage loan products, our mortgage loan production volume could decrease, which could harm our results of operations, financial condition and business prospects.

In addition, Fannie Mae and Freddie Mac are also expanding their participation in the subprime mortgage industry. These government-sponsored entities have a size and cost-of-funds advantage that allows them to purchase mortgage loans with lower rates or fees than we may be willing to offer. While the government-sponsored entities presently do not have the legal authority to originate mortgage loans, including subprime mortgage loans, they do have the authority to buy mortgage loans. A material expansion of their involvement in the market to purchase subprime mortgage loans could change the dynamics of the subprime industry by virtue of their sheer size, pricing power and the inherent advantages of a government charter. In addition, if as a result of their purchasing practices, these government-sponsored entities experience significantly higher-than-expected losses, such experience could harm the overall investor perception of the subprime mortgage industry.

Certain large finance companies and conforming mortgage originators also originate subprime mortgage loans to customers similar to the borrowers we serve. Competitors with lower costs of capital have a competitive advantage over us. In addition, establishing a wholesale lending operation such as ours requires a relatively small commitment of capital and human resources. This low barrier to entry permits new competitors to enter our markets quickly and compete with our wholesale lending business. If these competitors are able to attract some of our key employees and disrupt our broker relationships, it could harm our results of operations, financial condition and business prospects.

Some thrifts, national banks and their operating subsidiaries are also expanding their mortgage lending activities. By virtue of their charters, these institutions are exempt from complying with many of the state and local laws that affect our operations. For example, they are permitted to offer mortgage loans with prepayment charges in many jurisdictions where we cannot. If more of these federally chartered institutions are able to use their preemptive ability to provide more competitive pricing and terms than we can offer, it could harm our results of operations, financial condition and business prospects.

In addition, to the extent we purchase mortgage loans or mortgage-related assets from third parties, we will compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, other lenders and other entities that purchase mortgage loans or mortgage-backed securities, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient mortgage-related assets with favorable yields over our borrowing costs, which could harm our results of operations, financial condition and business prospects.

The intense competition in the mortgage industry has also led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements. As mortgage products are offered more widely through alternative distribution channels, such as the Internet, we may be required to make significant changes to our current wholesale and retail structures and information systems to compete effectively. Our inability to continue enhancing our current Internet capabilities, or to adapt to other technological changes in the industry, could harm our results of operations, financial condition and business prospects.

A prolonged economic slowdown or a lengthy or severe recession could harm our operations, particularly if it results in a decline in the real estate market.

The risks associated with our business are more acute during periods of economic slowdown or recession because these periods may be accompanied by decreased demand for consumer credit and declining real estate values. Declining real estate values reduce the ability of borrowers to use home equity to support borrowings because they reduce the LTV of the home equity collateral. In addition, because we make a substantial number of mortgage loans to credit-impaired borrowers, the actual rates of delinquencies, foreclosures and losses on these mortgage loans could be higher during economic slowdowns. Any sustained period of increased delinquencies, foreclosures or losses could harm our ability to sell mortgage loans, the prices we receive for our mortgage loans, or the values of our mortgage loans held for investment or our residual interests in securitizations, which could harm our results of operations, financial condition and business prospects.

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Our earnings may decrease because of increases or decreases in interest rates.

Our profitability may be directly affected by changes in interest rates. The following are some of the risks we face as a result of interest rate increases:

When we securitize mortgage loans, the income we receive and the value of the residual interests we retain from the securitizations structured as financings are based primarily on the London Inter-Bank Offered Rate, or LIBOR. This is because the interest on the underlying mortgage loans is based on fixed rates payable on the underlying mortgage loans for the first two or three years from origination while the holders of the applicable securities are generally paid based on an adjustable LIBOR-based yield. Therefore, an increase in LIBOR reduces the net income we receive from, and the value of, these mortgage loans and residual interests.

Our adjustable-rate mortgage loans have periodic and lifetime interest rate caps above which the interest rate on the mortgage loans may not rise. In the event of general interest rate increases, the rate of interest on these mortgage loans could be limited, while the rate payable on the senior certificates representing interests in a securitization trust into which these mortgage loans are sold may be uncapped. This would reduce the amount of cash we receive over the life of the mortgage loans in securitizations structured as financings and our residual interests, and could require us to reduce the carrying value of our residual interests.

Changes in interest rates may affect our net interest income, which is the difference between the interest income that we earn on our mortgage loans or mortgage-related assets and the interest expense that we incur in financing our assets through debt, including securitizations. We rely primarily on short-term borrowings to acquire assets with long-term maturities. Accordingly, increases in short-term interest rates as compared to long-term interest rates may negatively affect the value of our assets and our ability to realize gains from the sale of mortgage loans we originate for resale, which will ultimately affect our earnings. In a period of rising interest rates, our interest expense could increase in different amounts and at different rates and times than the interest that we earn on our assets. If the net differential between our interest income on our mortgage loan assets and our interest expense to carry such mortgage loans was reduced, our net interest income would be reduced. Interest rate fluctuations resulting in our interest expense exceeding our interest income could result in operating losses for us and may limit or eliminate our ability to make distributions to our shareholders.

A substantial and sustained increase in interest rates could harm our mortgage loan origination volume because refinancings of existing mortgage loans, including cash-out refinancings and interest rate-driven refinancings, would be less attractive and qualifying for a purchase mortgage loan may be more difficult. Lower origination volume may harm our earnings by reducing origination income, net interest income and gain on sale of mortgage loans.

During periods of rising interest rates, the value and profitability of our mortgage loans may be harmed between the date of origination or purchase until the date we sell or securitize the mortgage loans.

An increase in interest rates could increase the delinquency and default rates on the adjustable-rate mortgage loans that we originate and hold because the borrowers monthly payments under such mortgage loans may increase beyond the borrowers ability to pay. Our portfolio of mortgage-related assets includes a significant number of mortgage loans that were originated in 2004 and 2005 that are adjustable-rate mortgage loans. Due to significant increases in interest rates since those mortgage loans were originated, the borrowers may be facing a larger-than-expected payment increase once the initial two or three-year fixed period ends. This may result in higher delinquencies and/or faster prepayment speeds, both of which could harm our profitability. High delinquencies or losses may decrease our cash flows or impair our ability to sell or securitize mortgage loans in the future, which could harm our results of operations, financial condition and business prospects.

We are also subject to risks from decreasing interest rates. For example, a significant decrease in interest rates could increase the rate at which mortgage loans are prepaid, which also could require us to reduce the carrying value

of our residual interests. Moreover, if prepayments are greater than expected, the cash we

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receive over the life of our residual interests would be reduced. Higher-than-expected prepayments could also harm the value of our servicing portfolio. Therefore, any such changes in interest rates could harm our results of operations, financial condition and business prospects.

Our reliance on cash-out refinancings as a significant source of our origination volume increases the risk that our earnings will be harmed if the demand for this type of refinancing declines.

During the year ended December 31, 2005, approximately 48.4% of our mortgage loan production volume consisted of cash-out refinancings. This concentration increases the risk that our earnings will be reduced if interest rates rise and the prices of homes decline, which would reduce the demand and production volume for this type of refinancing. A substantial and sustained increase in interest rates could significantly reduce the number of borrowers who would qualify or elect to pursue a cash-out refinancing and result in a decline in that origination source. Similarly, a decrease in home prices would reduce the amount of equity available to be borrowed against in cash-out refinancings and result in a decrease in our mortgage loan production volume from that origination source. Therefore, our reliance on cash-out refinancings as a significant source of our origination volume could harm our results of operations, financial condition and business prospects.

Our accounting policies and methods are fundamental to how we report our financial condition and results of operations, and they may require management to make estimates about matters that are inherently uncertain.

We have identified several accounting policies as being critical to the presentation of our financial condition and results of operations because they require management to make particularly subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be recorded under different conditions or using different assumptions. These critical accounting policies relate to, without limitation, securitizations structured as financings, allowance for losses on mortgage loans held for investment, residual interests in securitizations, allowance for repurchase losses, gain on sale of mortgage loans, income taxes and derivative instruments designated and documented as hedges. Because of the inherent uncertainty of the estimates associated with these critical accounting policies, we cannot provide any assurance that we will not make significant subsequent adjustments to the related amounts recorded. For more information, please refer to the Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies section in this Report.

Our hedging strategies may not be successful in mitigating our risks associated with interest rates.

We use various derivative financial instruments to provide a level of protection against interest rate changes, but no hedging strategy can protect us completely. When rates change, we expect to record a gain or loss on derivatives, which would be offset by an inverse change in the value of mortgage loans or residual interests. Additionally, from time to time, we may enter into hedging transactions in connection with our holdings of mortgage-backed securities and government securities with respect to one or more of our assets or liabilities. Our hedging activities may include derivative financial instruments such as Euro Dollar futures contracts, interest rate cap agreements, interest rate swap agreements, Treasury futures and options on interest rates as well has hedging instruments such as mortgage derivative securities. Currently, we intend to primarily use Euro Dollar futures contracts, interest rate cap agreements and interest rate swap agreements to manage the interest rate risk of our portfolio of adjustable-rate mortgages; however, we may change our hedging strategy in the future depending on market factors. Under our current strategy, any significant decrease in interest rates could result in a significant margin call, which would require us to provide the counterparty with additional cash collateral. Any such margin call could harm our liquidity, results of operations, financial condition and business prospects.

The derivative financial instruments we select may not have the effect of reducing our interest rate risk. There have been periods, and it is likely that there will be periods in the future, during which we will incur losses after accounting for our derivative financial instruments. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies or improperly executed transactions could actually increase our risk and losses. Our hedging strategies also involve

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transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses, which losses could harm our results of operations, financial condition and business prospects.

An increase in mortgage loan prepayments may negatively affect the yields on our assets.

The value of the mortgage loans and any underlying securitization retained interests that we may hold will be affected by prepayment rates on those mortgage loans. Prepayment rates on mortgage loans are influenced by changes in interest rates and a variety of economic, geographic and other factors beyond our control. As a result, we are unable to predict prepayment rates with any certainty.

In periods of declining mortgage loan interest rates, prepayments on mortgage loans generally increase. We likely would reinvest the proceeds that we receive from those prepayments in mortgage loans and other assets with lower yields than the yields on the mortgage loans that were prepaid. As interest rates decline, the market value of fixed-income assets generally increases. However, because of the risk of prepayment, the market value of any mortgage loan or mortgage-related asset does not increase to the same extent as fixed-income securities in an environment of declining interest rates. Conversely, in periods of rising interest rates, prepayments on mortgage loans generally decrease, in which case we would not have the prepayment proceeds available to invest in assets with higher yields. Under certain interest rate and prepayment scenarios, we may fail to recoup fully our costs.

The mortgage loans that we hold are subject to the risks of delinquency and foreclosure loss, which could result in losses to us.

Our mortgage loans are secured by residential properties and are subject to risks of loss from delinquencies and foreclosures. The ability of a borrower to repay a mortgage loan secured by residential property typically is dependent primarily upon the income or assets of the borrower. In addition, the ability of borrowers to repay their mortgage loans may be affected by, among other things:

- property location and condition;
- competition and demand for comparable properties;
- changes in zoning laws for the property or its surrounding area;
- environmental contamination at the property;
- the occurrence of any uninsured casualty at the property;
- changes in national, regional or local economic conditions;
- declines in regional or local real estate values;
- increases in interest rates or real estate taxes;
- availability and costs of municipal services;
- changes in governmental rules, regulations and fiscal policies, including environmental legislation and changes in tax laws; and
- acts of God, war or other conflict, terrorism, social unrest and civil disturbances and natural disasters, such as hurricanes.

In the event of a default under a mortgage loan held directly by us, we will bear a risk of loss of principal to the extent of any deficiency between the value of the collateral that we can realize upon foreclosure and sale, and the principal and accrued interest of the mortgage loan and the cost of foreclosing on the related property. Losses resulting

from mortgage loan defaults and foreclosures could have a material adverse effect on our income and cash flow from operations and could limit the funds that we have available for distribution to our stockholders. We are exposed to greater risks of loss where we make both a first and second lien mortgage loans on the same property and do not have the benefits of private mortgage insurance. Our

underlying subordinated tranches in securitizations would also be affected adversely by losses on our mortgage loans that have been included in the related securitizations.

In the event of the bankruptcy of a mortgage loan borrower, the related mortgage loan will be deemed to be secured only to the extent of the value of the underlying collateral at the time of bankruptcy, as determined by the bankruptcy court. The lien securing the mortgage loan will be subject to the avoidance powers of the bankruptcy trustee or debtor-in-possession to the extent the lien is unenforceable under state law. Foreclosure of a mortgage loan can be an expensive and lengthy process that can have a substantial negative effect on our originally anticipated return on the foreclosed mortgage loan. Residential mortgage-backed securities evidence interests in, or are secured by, pools of residential mortgage loans. Accordingly, the subordinated tranches in the mortgage-backed securities that we hold are subject to all of the risks of the related mortgage loans. In addition, to the extent that the mortgage loans we originate experience relatively high rates of delinquency and/or foreclosure, then we may be unable to securitize our mortgage loans on terms that are attractive to us, if at all.

The geographic concentration of our mortgage loan originations increases our exposure to economic and natural hazard risks specific to those areas.

Over-concentration of our mortgage loan originations in any one geographic area increases our exposure to the economic and natural hazard risks associated with that area. For example, in the year ended December 31, 2005, approximately 37.4% of the aggregate principal amount of our mortgage loans was secured by properties located in California. Certain parts of California have experienced an economic downturn in the past and have suffered the effects of certain natural hazards. Declines in the residential real estate markets in which we are concentrated may reduce the values of the properties collateralizing our mortgages, increase the risk of delinquency, foreclosure, bankruptcy or losses and could harm our results of operations, financial condition and business prospects.

Furthermore, if borrowers are not insured for natural disasters, which are typically not covered by standard hazard insurance policies, then they may not be able to repair the property or may stop paying their mortgages if the property is damaged. A natural disaster, such as Hurricane Katrina, that results in a significant number of delinquencies would cause increased foreclosures and decrease our ability to recover losses on properties affected by such disasters and would harm our results of operations, financial condition and business prospects.

Likewise, the secondary market pricing for pools of mortgage loans that are not geographically diverse is typically less favorable than for a diverse pool. Our inability to originate or purchase geographically diverse pools of mortgage loans could harm our results of operations, financial condition and business prospects.

An interruption or reduction in the securitization and whole loan markets would harm our financial position.

We are dependent on the securitization market for the sale of our mortgage loans because we securitize mortgage loans directly and many of our whole loan buyers purchase our mortgage loans with the intention to securitize them. The securitization market is dependent upon a number of factors, including general economic conditions, conditions in the securities market generally and conditions in the asset-backed securities market specifically. In addition, poor performance of our previously securitized mortgage loans could harm our access to the securitization market. Accordingly, a decline in the securitization market or a change in the market s demand for our mortgage loans could harm our results of operations, financial condition and business prospects.

We may not realize all of the expected benefits of, and we may incur additional costs related to, the acquisition of a mortgage origination platform from RBC Mortgage.

On September 2, 2005, we acquired a mortgage origination platform from RBC Mortgage. It is too early to conclude whether we will realize the anticipated benefits of this acquisition, including expanded depth and breadth of our mortgage product offerings, expanded retail presence on a nationwide basis and expanded

channels of distribution, including into the realtor and builder channels. Moreover, our management has limited experience operating the recently acquired RBC Mortgage platform and integrating recently acquired businesses. At the same time, the ultimate costs associated with this acquisition may be higher than expected. In addition, the process of integrating an acquired business may result in operating difficulties, compliance errors and unanticipated expenditures and may require significant management attention that would otherwise be available for ongoing development of other aspects of our business.

If we make any additional acquisitions, we will incur a variety of costs and may never realize the anticipated benefits.

If appropriate opportunities become available, we may attempt to acquire businesses that we believe are a strategic fit with our business. We currently have no agreements to consummate any material acquisitions. If we pursue any such transaction, the process of negotiating the acquisition and integrating an acquired business may result in operating difficulties and expenditures and may require significant management attention that would otherwise be available for ongoing development of our business, whether or not any such transaction is ever consummated. Moreover, we may never realize the anticipated benefits of any acquisition. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt, contingent liabilities and/or amortization expenses related to goodwill and other intangible assets, which could harm our results of operations, financial condition and business prospects.

Our earnings from holding mortgage-backed securities or government securities may be harmed by changes in the level of interest rates, changes to the difference between short- and longer- term interest rates, changes to the difference between interest rates for these securities compared to other debt instruments, and an absence of or reduction in the availability, at favorable terms, of repurchase financing and other liquidity sources typically utilized by mortgage REITs.

From time to time, we may purchase mortgage-backed securities or government securities from third parties in order to comply with the income and asset tests necessary to maintain our REIT status. The value of, and return on, the mortgage-backed securities and government securities we hold will be affected by changes in the marketplace for such securities, as well as prepayment speeds in the case of mortgage-backed securities, and may be volatile and significantly different than anticipated. The securities that we hold may produce large losses instead of the income that we expect. The impact of changes in the marketplace for these securities on our results may be magnified because these holdings could be highly leveraged. Additionally, much of the financing we will use to hold these securities may be cancelable by our lenders on short notice. If our lenders cease providing financing to us on favorable terms, we would be forced to liquidate some or all of these securities, possibly at a substantial loss, which could harm our financial condition, results of operations and business prospects.

A material difference between the assumptions used in the determination of the value of our residual interests and our actual experience could harm our financial position.

As of December 31, 2005, the value on our balance sheet of our residual interests from securitization transactions was $234.9 million. The value of these residual interests is a function of the delinquency, loss, prepayment speed and discount rate assumptions we use. It is extremely difficult to validate the assumptions we use in valuing our residual interests. In the future, if our actual experience differs materially from these assumptions, our cash flow, financial condition, results of operations and business prospects may be harmed.

We may be required to conform to the standards of the recent Ameriquest settlement, which could harm our business.

In January 2006, ACC Capital Holding Corporation and its subsidiaries Ameriquest Mortgage Company, Town & Country Credit Corporation and AMC Mortgage Services Inc., formerly known as Bedford Home Loans, which we refer to collectively as Ameriquest, reached a settlement with various state Attorneys General resolving some of the regulatory complaints and consumer claims made against Ameriquest related to predatory home mortgage lending. By the terms of the settlement, the second largest federal consumer

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protection settlement in history, Ameriquest agreed to implement certain new standards and to pay $325 million to the states, with most of the money to be used to pay restitution to consumers who obtained mortgage loans from Ameriquest between January 1999 and December 2005.

In the settlement, Ameriquest denied all allegations but agreed to implement certain new standards and practices meant to prevent a recurrence of its alleged abuses and unfair and deceptive practices. Many of the settlement s requirements far exceed any express requirements of existing lending laws. Although we believe our historical controls and practices have operated effectively to mitigate the risk of the abuses alleged in the Ameriquest settlement, in many cases our controls and policies are not identical to those prescribed by the Ameriquest settlement. However, some Attorneys General have made public statements that the conduct required by the Ameriquest settlement should be seen as new standards applicable to the entire industry and that they may pursue actions against lenders who do not adhere the new standards. If the Attorneys General seek to apply these standards to the entire industry or our company in particular, some of our own practices could be called into question and our revenues, business, results of operations and profitability could be harmed. In addition, if it becomes accepted practice that settlements entered with Attorneys General establish new standards for the industry as a whole and supercede existing express legislative requirements, the standards by which we are governed will become less predictable and the risks associated with our business will increase.

New legislation could restrict our ability to make mortgage loans, which could harm our earnings.

Several states and cities are considering or have passed laws, regulations or ordinances aimed at curbing predatory lending practices. The federal government is also considering legislative and regulatory proposals in this regard. In general, these proposals involve lowering the existing federal Homeownership and Equity Protection Act thresholds for defining a high-cost mortgage loan and establishing enhanced protections and remedies for borrowers who receive such mortgage loans. However, many of these laws and rules extend beyond curbing predatory lending practices to restrict commonly accepted lending activities, including some of our activities. For example, some of these laws and rules prohibit any form of prepayment charge or severely restrict a borrower s ability to finance the points and fees charged in connection with the borrower s mortgage loan. In addition, some of these laws and regulations provide for extensive assignee liability for warehouse lenders, whole loan buyers and securitization trusts. Because of enhanced risk and for reputational reasons, many whole loan buyers elect not to purchase any mortgage loan labeled as a high cost mortgage loan under any local, state or federal law or regulation. Accordingly, these laws and rules could severely constrict the secondary market for a significant portion of our mortgage loan production. This would effectively preclude us from continuing to originate mortgage loans that fit within the newly defined thresholds.

Some of our competitors who are, or are owned by, national banks or federally chartered thrifts may not be subject to these laws and may, therefore, be able to capture market share from us and other lenders. Passage of such state and local laws could increase compliance costs and reduce fee income and origination volume, all of which would harm our results of operations, financial condition and business prospects.

Lawsuits challenging our business practices, our competitors and other companies are pending and more may be filed in the future.

We are named as a defendant in a number of lawsuits challenging various aspects of our business operations and seeking significant monetary damages. These cases allege violations of the Fair Credit Reporting Act, or FCRA, failure to pay overtime wages, the making of mortgage loans with fees greater than permitted by law and advertising practices and interference with broker relationships, among other matters. Additional litigation may be filed against us or disputes may arise in the future concerning these or other business practices. In addition, lawsuits have been filed, and other lawsuits may be filed in the future, against our competitors and other businesses, and although we are not a party to such litigation, the results of such lawsuits may create additional risks for, or impose additional costs or limitations on, our business operations.

As courts resolve individual or class action litigation related to our industry, regulations and standards could emerge necessitating material increases in our costs of doing business or preventing us from participating

in certain business activities in which we currently engage. For instance, if claims by various plaintiffs that prescreened offers of credit do not qualify as firm offers of credit under the FCRA, and thus that we are not authorized to access certain consumer credit reports in relation to such offers, prevail, our business practices and ability to offer and close certain lines of credit would be impaired and our revenues, results of operations, business and profitability could be harmed.

The outcome of litigation and other legal matters is always uncertain. One or more legal matters could result in losses material to our financial condition, results of operations, business and profitability. A description of material legal actions in which we are involved is included under Legal Proceedings in Item 3.

The scope of our lending and servicing operations exposes us to risks of noncompliance with an increasing and inconsistent body of complex laws and regulations at the federal, state and local levels.

Because we are authorized to originate and service mortgage loans in all 50 U.S. states, we must comply with the laws and regulations, as well as judicial and administrative decisions, in all of these jurisdictions, as well as an extensive body of federal law and regulations. The volume of new or modified laws and regulations has increased in recent years, and individual cities and counties have begun to enact laws that restrict mortgage loan origination and servicing activities. The laws and regulations of each of these jurisdictions are different, complex and, in some cases, in direct conflict with each other. Moreover, plaintiffs are beginning to attack the legality of origination and servicing practices that are customary in the mortgage loan industry. As our operations continue to grow, it may be more difficult to comprehensively identify, accurately interpret and properly program our technology systems and effectively train our personnel with respect to all of these laws and regulations, thereby potentially increasing our exposure to the risks of noncompliance with these laws and regulations.

Our failure to comply with these laws can lead to:

- civil and criminal liability;
- loss of licensure;
- damage to our reputation in the industry;
- inability to sell or securitize our mortgage loans;
- demands for indemnification or mortgage loan repurchases from purchasers of our mortgage loans;
- fines and penalties and litigation, including class action lawsuits; or
- administrative enforcement actions.

Any of these results could harm our results of operations, financial condition and business prospects.

Our interest-only mortgage loans may have a higher risk of default than our fully-amortizing mortgage loans and, therefore, may be considered less valuable than other types of mortgage loans in the sales and securitization process.

During the year ended December 31, 2005, originations of interest-only mortgage loans totaled $17.3 billion, or 30.7%, of total originations. Until the fourth quarter of 2005, most of these interest only mortgage loans required the borrower to make monthly payments only of accrued interest for the first two or three years, corresponding to the initial fixed-rate period of these mortgage loans. Since then, we changed our product design to provide for interest only payments for at least the first 5 years following origination. The interest-only feature may reduce the likelihood of prepayment during the interest-only period due to the smaller monthly payments relative to a fully-amortizing mortgage loan. However, upon expiration of the interest-only payment, the borrower s payment will increase to cover the fully amortizing payment. The adjustment to the higher payment amount increases the risk that the borrower will default or prepay the mortgage loan. Because no principal payments may be made on such mortgage loans for an extended period following origination, if the borrower defaults, the unpaid principal balance of the related mortgage

loan will be greater than otherwise would be the case, increasing the risk of loss in that situation. For those reasons,

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among others, these interest-only mortgage loans may be less valuable in the secondary market and may result in lesser proceeds to us when sold or securitized as compared to fully amortizing mortgage loans.

We may incur losses on our mortgage loans even if the mortgage loans are insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

Originations in connection with our recently acquired RBC Mortgage platform include mortgage loans insured by the Federal Housing Administration and mortgage loans guaranteed by the Veterans Administration. While those insured mortgage loans and guaranteed mortgage loans are generally subject to a lower risk of default than mortgage loans that are not insured or guaranteed, there can be no assurance that our insured mortgage loans and guaranteed mortgage loans will not be subject to credit losses. The Federal Housing Administration only insures against foreclosure and the Veterans Administration only partially guarantees the losses that we incur as a result of foreclosure. Moreover, neither the insurance nor the guarantees take into account the interest rate risks, prepayment risks, extension risks or other risks associated with mortgage loans. In addition, the insurance and the guarantees do not protect us against a reduction in the market value of the mortgage loans. As a result, while we attempt to mitigate our exposure to credit risk for certain of our mortgage loans by obtaining insurance from the Federal Housing Administration and guarantees from the Veterans Administration, we cannot eliminate all such credit risks and remain subject to other risks related to mortgage loans and may suffer losses, which may harm the market price of our securities.

The loss of our exemption under the Investment Company Act would harm us and the market price of our shares of common stock and our ability to make distributions to our stockholders.

We are not currently regulated as an investment company under the Investment Company Act of 1940, as amended, or the Investment Company Act, and we intend to operate so as to not become regulated as an investment company under the Investment Company Act. For example, we intend to qualify for an exemption under the Investment Company Act that is available to companies that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Specifically, we intend to invest at least 55% of our assets in mortgage loans or mortgage-related assets securities that represent the entire ownership in a pool of mortgage loans and at least an additional 25% of our assets in mortgages, mortgage-related assets securities, securities of REITs and other real estate-related assets. As of December 31, 2005, 61.7% of our assets consisted of mortgage loans or mortgage-related assets that represent the entire ownership in a pool of mortgage loans and another 30.8% of our assets were invested in mortgages, mortgage-related assets, securities of REITs and other real estate-related assets.

If we fail to qualify for that exemption, we may be required to restructure our activities. For example, if the market value of our investments in equity securities were to increase by an amount that caused less than 55% of our assets to be invested in mortgage loans or mortgage-related assets that represent the entire ownership in a pool of mortgage loans, we might have to sell equity securities in order to qualify for an exemption under the Investment Company Act. In the event we must restructure our activities, such restructuring could harm our results of operations, financial condition and business prospects.

Our inability to realize cash proceeds from mortgage loan sales and securitizations in excess of the loan acquisition cost could harm our financial position.

The net cash proceeds received from mortgage loan sales consist of the premiums we receive on sales of mortgage loans in excess of the outstanding principal balance, plus the cash proceeds we receive from securitizations structured as sales, minus the discounts on mortgage loans that we have to sell for less than the outstanding principal balance. If we are unable to originate mortgage loans at a cost lower than the cash proceeds realized from mortgage loan sales, such inability could harm our results of operations, financial condition and business prospects.

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Our credit facilities are subject to margin calls based on the lender s opinion of the value of our mortgage loan collateral. An unanticipated large margin call could harm our liquidity.

The amount of financing we receive under our credit facilities depends in large part on the lender s valuation of the mortgage loans that secure the financings. Each such facility provides the lender the right, under certain circumstances, to reevaluate the mortgage loan collateral that secures our outstanding borrowings at any time. In the event the lender determines that the value of the mortgage loan collateral has decreased, it has the right to initiate a margin call. A margin call would require us to provide the lender with additional collateral or to repay a portion of the outstanding borrowings. Any such margin call could harm our liquidity, results of operations, financial condition and business prospects.

Our origination and servicing systems depend significantly on automated controls and any failure of these systems could harm our business.

We are increasingly dependent on automated systems and technology to operate our business, enhance customer service and achieve low operating costs. Our origination and servicing systems rely heavily on automated controls. The performance and reliability of our automated systems are critical to our ability to operate our business and compete effectively.

Given our high volume of transactions, certain errors in our automated systems may be repeated or compounded before they are discovered and successfully corrected. If we misinterpret or incorrectly implement a legal standard in our automated systems, the error may be replicated numerous times before it is fixed. In addition, technical system flaws or employee tampering or manipulation of our automated systems may result in losses that are difficult to detect. We also face the risk that the design of our controls and procedures prove inadequate or are circumvented, thereby causing delays in detection or errors in information. In addition, we are exposed to the risk that our external vendors may not fulfill their contractual obligations to us.

Our automated systems cannot be completely protected against events that are beyond our control, including natural disasters, computer viruses or telecommunications failures. Our business continuity and data security systems may prove inadequate to allow us to resume operations in the event of a disruption to our operations. There can be no assurance that we will not suffer losses from operational risks in the future that may be material in amount. Substantial or sustained system failures could impact customer service. Any disruptions in these systems due to internal failures of technology or large-scale external interruptions in technology infrastructure, such as power, telecommunications or the internet, could result in the loss of revenue or important data, increase our expenses and generally harm our business.

Our efforts to increase our servicing activities may be unsuccessful and a decline in the quality of servicing could lower the value of our residual interests and our ability to sell or securitize mortgage loans and could harm the cash flows from our securitizations structured as financings.

We have devoted a significant amount of our resources and expenditures in recent periods to expanding our servicing capabilities. During the past two years, we have completed several servicing platform technology initiatives and moved our servicing platform to a new larger facility to allow for increased servicing capacity and growth of our servicing activity. We may not realize the expected benefits from these initiatives and the expected benefits we do realize may not occur until future periods. If we are unable to realize the expected benefits of the expansion of our servicing capabilities, our revenues, business, results of operations and profitability could suffer and we would have less funds available for distribution to our stockholders. In addition, a weakened ability to service mortgage loans could disadvantage us against our competitors in the market for sales and securitizations of mortgage loans in the secondary market and harm our ongoing business relationships, and ability to effect repeat business, with borrowers in need of new mortgage loans or seeking to refinance existing mortgage loans.

A decline in the quality of servicing we provide could lead to higher levels of delinquencies, realized losses, interest expenses and subordination levels of our securitizations. In addition, our historical delinquency, bankruptcy, foreclosure or default estimates may ultimately prove inaccurate, which would prevent us from

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accurately predicting the future delinquency and loss experience of the mortgage loans we service. The effectiveness of our loss mitigation strategies may suffer as a result and any higher default rate resulting from delinquencies may harm our revenues, business, results of operations and profitability. High costs and significant funding required to maintain large subordinated interests in securitizations would reduce our profitability and growth and harm our financial condition.

We are subject to losses due to fraudulent and negligent acts on the part of mortgage loan applicants, mortgage brokers, other vendors and our employees.

When we originate mortgage loans, we rely heavily upon information supplied by third parties, including the information contained in the mortgage loan application, property appraisal, title information and employment and income documentation. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the value of the mortgage loan may be significantly lower than expected. Whether a misrepresentation is made by the mortgage loan applicant, the mortgage broker, another third party or one of our employees, we generally bear the risk of loss associated with the misrepresentation. A mortgage loan subject to a material misrepresentation is typically unsaleable or subject to repurchase if it is sold prior to detection of the misrepresentation, and the persons and entities involved are often difficult to locate and it is often difficult to collect any monetary losses that we have suffered from them.

We have controls and processes designed to help us identify misrepresented information in our mortgage loan origination operations. However, no degree of controls can provide assurance that we have detected or will detect all misrepresented information in our mortgage loan originations.

We may be subject to fines or other penalties based upon the conduct of our independent brokers.

The mortgage brokers from whom we obtain mortgage loans have parallel and separate legal obligations to which they are subject. While these laws may not explicitly hold the originating lenders responsible for the legal violations of mortgage brokers, increasingly federal and state agencies have sought to impose such liability on parties that take assignments of such mortgage loans. The United States Justice Department in the past has sought to hold a mortgage lender responsible for the pricing practices of its mortgage brokers, alleging that the mortgage lender was directly responsible for the total fees and charges paid by the borrower under the Fair Housing Act even if the lender neither dictated what the mortgage broker could charge nor kept the money for its own account. Accordingly, we may be subject to fines or other penalties based upon the conduct of our independent mortgage brokers.

We are dependent upon third parties for many of our significant administrative and financial processes.

To lower our costs and provide more competitive products for our customers, we are shifting various administrative and financial processes, particularly in the areas of human resources, accounts payable and procurement, to Accenture LLP and other third party vendors. Our inability to properly transfer administrative and financial processes or any failed or less than optimal execution by a third party vendor, including any disruptions, delays or failure in service, could harm our revenues, business, results of operations and profitability, be costly and disruptive to our business and decrease the funds we would have available for distribution to our shareholders. Delays in the implementation of Accenture s business process outsourcing capabilities or in the effective use of other third party vendors could harm our ability to meet our cost reduction goals.

Should Accenture or any of our other third party vendors wish to terminate or modify our arrangements with them, we would incur transition costs, which would likely be significant, to switch to another vendor. A change in vendors may require significant lead-time. A prolonged inability to obtain these processes could have an adverse effect on our financial condition.

Changes in the volume and cost of mortgage loans originated by our Wholesale Division may decrease our mortgage loan production and decrease our earnings.

We depend primarily on independent mortgage brokers and, to a lesser extent, on correspondent lenders for the origination and purchase of our wholesale mortgage loans, which constitute the majority of our mortgage loan production. These independent mortgage brokers have relationships with multiple lenders and are not obligated by contract or otherwise to do business with us. We compete with these lenders for the independent brokers business on pricing, service, loan fees, costs and other factors. Competition from other lenders and purchasers of mortgage loans could negatively affect the volume and pricing of our wholesale mortgage loans, which could harm our results of operations, financial condition and business prospects.

If many of our borrowers become subject to the Servicemembers Civil Relief Act of 2003, our cash flows from our residual securities and our securitizations structured as financings may be harmed.

Under the Servicemembers Civil Relief Act, which in 2003 re-enacted the Soldiers and Sailors Civil Relief Act of 1940, a borrower who enters military service after the origination of the borrower s mortgage loan generally may not be charged interest above an annual rate of 6% during the period of the borrower s active duty status. The Act also applies to a borrower who was on reserve status and is called to active duty after origination of the mortgage loan. A prolonged, significant military mobilization as part of the war on terrorism or the war in Iraq could increase the number of the borrowers in our securitized pools who are subject to the Act and thereby reduce the interest payments collected from those borrowers. To the extent the number of borrowers who are subject to the Act is significant, the cash flows we receive from mortgage loans underlying our securitizations structured as financings and from our residual interests would be reduced, which could cause us to reduce the carrying value of our residual interests and could decrease our earnings. In addition, the Act imposes limitations that would impair the ability of the servicer to foreclose on an affected mortgage loan during the borrower s period of active duty status, and, under certain circumstances, during an additional three month period thereafter. Any such reduction in our cash flows or impairment in our performance could harm our results of operations, financial condition and business prospects.

The inability to attract and retain qualified employees could significantly harm our business.

We depend on our wholesale account executives and retail mortgage loan officers to attract borrowers by, among other things, developing relationships with financial institutions, other mortgage companies and brokers, real estate agents, borrowers and others. We believe that these relationships lead to repeat and referral business. The market for skilled account executives and mortgage loan officers is highly competitive and historically has experienced a high rate of turnover. In addition, if a manager is no longer employed by us, there is an increased likelihood that other members of his or her team will leave our employ as well. Competition for qualified account executives and mortgage loan officers may lead to increased hiring and retention costs. If we are unable to attract or retain a sufficient number of skilled account executives at manageable costs, we will be unable to continue to originate quality mortgage loans that we are able to sell for a profit, which would harm our results of operations, financial condition and business prospects.

An interruption in or breach of our information systems may result in lost business.

We rely heavily upon communications and information systems to conduct our business. Any failure or interruption or breach in security of our information systems or the third-party information systems on which we rely could cause underwriting or other delays and could result in fewer mortgage loan applications being received, slower processing of applications and reduced efficiency in mortgage loan servicing. We are required to comply with significant federal and state regulations with respect to the handling of customer information, and a failure, interruption or breach of our information systems could result in regulatory action and litigation against us. We cannot assure you that such failures or interruptions will not occur or if they do occur that they will be adequately addressed by us or the third parties on which we rely. The occurrence of any failures or interruptions could harm our results of operations, financial condition and business prospects.

The success and growth of our business will depend upon our ability to adapt to and implement technological changes.

Our mortgage loan origination business is currently dependent upon our ability to effectively interface with our brokers, borrowers and other third parties and to efficiently process mortgage loan applications and closings. The origination process is becoming more dependent upon technological advancement, such as the ability to process applications over the Internet, accept electronic signatures and provide process status updates instantly and other customer-expected conveniences that are cost-efficient to our process. In addition, we have recently implemented a new mortgage loan origination system. Becoming proficient with the new mortgage loan origination system and other new technology will require significant financial and personnel resources. There is no guarantee that the implementation of our new mortgage loan origination system or other new technology will be successful. To the extent that we become reliant on any particular technology or technological solution, we may be harmed to the extent that such technology or technological solution (i) becomes non-compliant with existing industry standards, (ii) fails to meet or exceed the capabilities of our competitors equivalent technologies or technological solutions, (iii) becomes increasingly expensive to service, retain and update, or (iv) becomes subject to third-party claims of copyright or patent infringement. Any failure to acquire technologies or technological solutions when necessary could limit our ability to remain competitive in our industry and could also limit our ability to increase the cost-efficiencies of our operating model, which would harm our results of operations, financial condition and business prospects.

We may be required to repurchase mortgage loans or indemnify investors if we breach representations and warranties, which could harm our earnings.

When we sell mortgage loans, we are required to make customary representations and warranties about such mortgage loans to the purchaser. Our whole loan sale agreements require us to repurchase or substitute mortgage loans in the event we breach a representation or warranty given to the mortgage loan purchaser or make a misrepresentation during the mortgage loan origination process. In addition, we may be required to repurchase mortgage loans as a result of borrower fraud or in the event of early payment default on a mortgage loan. Likewise, we are required to repurchase or substitute mortgage loans if we breach a representation or warranty in connection with our securitizations. The remedies available to a purchaser of mortgage loans are generally broader than those available to us against the originating broker or correspondent. Further, if a purchaser enforces its remedies against us, we may not be able to enforce the remedies we have against the sellers. The repurchased mortgage loans typically can only be financed at a steep discount to their repurchase price, if at all. They are also typically sold at a significant discount to the unpaid principal balance. Significant repurchase activity could harm our cash flow, results of operations, financial condition and business prospects.

We are exposed to risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, we may foreclose and take title to residential properties and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation, and cleanup costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our cash flow, results of operations, financial condition and business prospects could be harmed.

If we do not manage our growth effectively, our financial performance could be harmed.

In recent years, we have experienced rapid growth that has placed, and will continue to place, certain pressures on our management, administrative, operational and financial infrastructure. As of December 31, 2000, we had approximately 1,500 employees and by December 31, 2005, we had approximately 7,200 employees. Many of these employees have a limited understanding of our systems and controls. The increase

in the size of our operations may make it more difficult for us to ensure that we originate quality mortgage loans and that we service them effectively. We will need to attract and hire additional sales and management personnel in an intensely competitive hiring environment in order to preserve and increase our market share. At the same time, we will need to continue to upgrade and expand our financial, operational and managerial systems and controls.

We may change our policies in ways that harm our financial condition or results of operations.

Our investment and financing policies and our policies with respect to other activities, including our growth, debt capitalization, distributions, REIT status and operating policies are determined by our board of directors. Our board of directors may change these policies at any time without a vote of our stockholders. A change in these policies might harm our financial condition, results of operations or business prospects.

Compliance with the Sarbanes-Oxley Act of 2002 and proposed and recently enacted changes in securities laws and regulations are likely to increase our costs.

The Sarbanes-Oxley Act of 2002 and rules and regulations promulgated by the Securities and Exchange Commission and the NYSE have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices for public companies, including ourselves. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly to serve on our audit committee.

Risks Related to New Century Securities

The stock price and trading volume of New Century common stock may be volatile, which could result in substantial losses for stockholders and harm our ability to access the capital markets in the future.

The market price of New Century common stock may be highly volatile and subject to wide fluctuations that are unrelated to our operating performance. In addition, the trading volume in New Century common stock may fluctuate and cause significant price variations to occur. Some of the factors that could negatively affect our share price or result in fluctuations in the price or trading volume of New Century common stock include:

- general market and economic conditions;
- actual or anticipated changes in our future financial performance;
- changes in market interest rates;
- competitive developments, including announcements by us or our competitors of new products or services or significant contracts, acquisitions, strategic partnerships or capital commitments;
- the operations and stock performance of our competitors;
- developments in the mortgage lending industry or the financial services sector generally;
- the impact of new state or federal legislation or court decisions restricting the activities of lenders or suppliers of credit in our market;
- fluctuations in our quarterly operating results;
- changes in financial estimates by securities analysts;
- additions or departures of senior management and key personnel; and
- actions by institutional stockholders.

We cannot assure you that the market price of New Century common stock will not fluctuate or decline significantly in the future. In addition, the stock market in general can experience considerable price and volume

fluctuations. This volatility may make it difficult for us to access the capital markets through

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additional secondary offerings of New Century common stock, regardless of our financial performance, and such difficulty may preclude us from being able to take advantage of certain business opportunities or meet our obligations, which could, in turn, harm our results of operations, financial condition and business prospects.

Future sales of shares of New Century common stock, including shares of common stock by our insiders, may depress the price of New Century common stock.

Any sales of a substantial number of shares of New Century common stock, or the perception that those sales might occur, may cause the market price of New Century common stock to decline. We are unable to predict whether significant numbers of shares will be sold in the open market in anticipation of or following a sale by insiders.

Our board of directors may authorize the issuance of additional securities that may cause dilution and may depress the price of New Century securities.

Our charter permits our board of directors, without our stockholders approval, to:

- authorize the issuance of additional common stock or preferred stock in connection with future equity offerings or acquisitions of securities or other assets of companies; and

- classify or reclassify any unissued common stock or preferred stock and to set the preferences, rights and other terms of the classified or reclassified shares, including the issuance of shares of preferred stock that have preference rights over the common stock and existing preferred stock with respect to dividends, liquidation, voting and other matters or shares of common stock that have preference rights over common stock with respect to voting.

The issuance of additional shares of New Century securities could be substantially dilutive to our existing stockholders and may depress the price of New Century securities.

Future offerings of debt securities, which would be senior to New Century common stock and preferred stock in liquidation, or equity securities, which would dilute our existing stockholders interests and may be senior to New Century common stock or existing preferred stock for the purposes of distributions, may harm the market price of New Century securities.

We will continue to seek to access the capital markets from time to time by making additional offerings of debt and/or equity securities, including commercial paper, medium-term notes, senior or subordinated notes, preferred stock or common stock. We are not precluded by the terms of our charter from issuing additional indebtedness. Accordingly, we could become more highly leveraged, resulting in an increase in debt service obligations that could harm our ability to make expected distributions to stockholders and in an increased risk of default on our obligations. If we were to liquidate, holders of our debt and lenders with respect to other borrowings would receive a distribution of our available assets before the holders of New Century common stock and preferred stock. Additional equity offerings by us may dilute our existing stockholders interest in us or reduce the market price of existing New Century securities. Our Series A Preferred Stock has, and our other preferred stock, if issued, could have, a preference on distribution payments that could limit our ability to make a distribution to holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Further, market conditions could require us to accept less favorable terms for the issuance of our securities in the future. Thus, our existing stockholders will bear the risk of our future offerings reducing the market price of New Century securities and diluting their ownership interest in us.

The stock ownership limit imposed by our charter may inhibit market activity in our stock and may restrict our business combination opportunities.

In order for us to maintain our qualification as a REIT under the Code, not more than 50% in value of the outstanding shares of our capital stock may be owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain entities) at any time during the last half of each taxable year after our first REIT taxable year. Our charter, with certain exceptions, authorizes our board of directors to take such actions as are necessary and desirable to preserve our qualification as a REIT and provide that, unless exempted by our board of directors, no single stockholder, or any group of affiliated stockholders, may beneficially own more than 9.8%, as such percentage may be modified by our board of directors from time to time, in value or in number of shares, whichever is more restrictive, of the aggregate of the outstanding shares of any class or series of our capital stock. Our board of directors also has authority under our charter to impose a similar ownership limitation as to any separate class or series of preferred stock we may issue in the future. Our board of directors may grant an exemption from that ownership limit in its sole discretion, subject to such conditions, representations and undertakings as it may determine and as are consistent with ensuring compliance with the REIT provisions of the Code.

Our charter also prohibits anyone from buying shares if the purchase would result in us losing our REIT status. If you or anyone else acquires shares in excess of the ownership limit or in violation of the ownership requirements of the Code for REITs, we:

- will consider the transfer to be null and void;
- will not reflect the transaction on our books;
- may institute legal action to enjoin the transaction;
- will not pay dividends or other distributions with respect to those shares;
- will not recognize any voting rights for those shares; and
- will consider the shares held in trust for the benefit of a charitable beneficiary as designated by us.

The trustee shall sell the shares held in trust and the owner of the excess shares will be entitled to the lesser of:

(1) the price paid by the transferee;

(2) if the transferee did not purchase the excess shares, the closing price for the shares on the national securities exchange on which the New Century securities are listed or quoted on the day of the event causing the shares to be held in trust; or

(3) the price received by the trustee from the sale of the shares.

This ownership limit could delay or prevent a transaction or a change in our control that might involve a premium price for New Century common stock or otherwise be in your best interest and may result in the entrenchment of our board of directors and management regardless of performance.

Certain provisions of Maryland law and our charter and bylaws could hinder, delay or prevent a change in control.

Certain provisions of Maryland law and our charter and bylaws could have the effect of discouraging, delaying or preventing transactions that involve an actual or threatened change in control of us, and may have the effect of entrenching our management and members of our board of directors, regardless of performance. These provisions include the following:

- *Classified board of directors.* Our board of directors is divided into three classes with staggered terms of office of three years each. The classification and staggered terms of office of our directors make it more difficult for a third party to gain control of our board of directors. At least two annual meetings of

stockholders, instead of one, generally would be required to effect a change in a majority of our board of directors.

Removal of directors. Under our charter, subject to the rights of one or more classes or series of preferred stock to elect one or more directors, a director may be removed only for cause and only by the affirmative vote of at least two-thirds of all votes entitled to be cast by our stockholders generally in the election of directors.

Number of directors, board vacancies, term of office. Under our bylaws, we have elected to be subject to certain provisions of Maryland law which vest in the board of directors the exclusive right to determine the number of directors and the exclusive right, by the affirmative vote of a majority of the remaining directors, to fill vacancies on the board of directors even if the remaining directors do not constitute a quorum. These provisions of Maryland law, which are applicable even if other provisions of Maryland law or the charter or bylaws provide to the contrary, also provide that any director elected to fill a vacancy shall hold office for the remainder of the full term of the class of directors in which the vacancy occurred, rather than the next annual meeting of stockholder as would otherwise be the case, and until his or her successor is elected and qualified.

Limitation on stockholder requested special meetings. Our bylaws provide that our stockholders have the right to call a special meeting only upon the written request of our stockholders entitled to cast not less than a majority of all the votes entitled to be cast by our stockholders at such meeting.

Advance notice provisions for stockholder nominations and proposals. Our bylaws require advance written notice for our stockholders to nominate persons for election as directors at, or to bring other business before, any meeting of our stockholders. This bylaw provision limits the ability of our stockholders to make nominations of persons for election as directors or to introduce other proposals unless we are notified in a timely manner prior to the meeting.

Exclusive authority of our board to amend our bylaws. Our bylaws provide that the board of directors has the exclusive power to adopt, alter or repeal any provision of our bylaws or to make new bylaws. Thus, our stockholders may not effect any changes to our bylaws.

Preferred stock. Under our charter, the board of directors has authority to issue preferred stock from time to time in one or more series and to establish the terms, preferences and rights of any such series of preferred stock, all without approval of our stockholders.

Duties of directors with respect to unsolicited takeovers. Maryland law provides protection for Maryland corporations against unsolicited takeovers by limiting, among other things, the duties of the directors in unsolicited takeover situations. The duties of directors of Maryland corporations do not require them to (i) accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation, (ii) authorize the corporation to redeem any rights under, or modify or render inapplicable, any stockholders rights plan, (iii) make a determination under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act, or (iv) act or fail to act solely because of the effect of an act or failure to act may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition. Moreover, under Maryland law the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.

Ownership limit. In order for us to maintain our qualification as a REIT under the Code, our charter, with certain exceptions, authorizes our board of directors to take such actions as are necessary and desirable to preserve our qualification as a REIT and provide that, unless exempted by our board of directors, no single stockholder, or any group of affiliated stockholders, may beneficially owning more than 9.8%, as such percentage may be modified by the Board of Directors from time to time, in value or number of shares, whichever is more restrictive, of the aggregate of the outstanding shares of any

class or series of our capital stock. Our board of directors also has authority under our charter to impose a similar ownership limitation as to any separate class or series of preferred stock we may issue in the future. Our board of directors may grant an exemption from that ownership limit in its sole discretion, subject to such conditions, representations and undertakings as it may determine and as are consistent with ensuring compliance with the REIT provisions of the Code.

Maryland Business Combination Act. The Maryland Business Combination Act provides that unless exempted, a Maryland corporation may not engage in business combinations, including mergers, dispositions of 10% or more of its assets, certain issuances of shares of stock and other specified transactions, with an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder became an interested stockholder, and thereafter unless specified criteria are met. An interested stockholder is generally a person owning or controlling, directly or indirectly, 10% or more of the voting power of the outstanding stock of a Maryland corporation. Our board of directors has adopted a resolution exempting it from this statute. However, our board of directors may repeal or modify this resolution in the future, in which case the provisions of the Maryland Business Combination Act will be applicable to business combinations between us and other persons.

Maryland Control Share Acquisition Act. Maryland law provides that control shares of a corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes eligible to be cast on the matter under the Maryland Control Share Acquisition Act. Control shares means shares of stock that, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of the voting power: one tenth or more but less than one third, one third or more but less than a majority or a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights or control shares acquired in a control share acquisition are not approved at a stockholders meeting, then subject to certain conditions and limitations, the issuer may redeem any or all of the control shares for fair value. If voting rights of such control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal rights. Our bylaws contain a provision exempting acquisitions of our shares from the Maryland Control Share Acquisition Act. However, our board of directors may amend our bylaws in the future to repeal or modify this exemption, in which case any control shares acquired in a control share acquisition will be subject to the Maryland Control Share Acquisition Act.

We may be contractually prohibited from paying dividends.

Several of our credit agreements contain prohibitions against our payment of any dividend at any time when there is a default under those credit agreements. A default for this purpose includes a failure to comply with various covenants, including reporting obligations and other nonmonetary obligations, as well as financial conditions that may be beyond our control. A default for this purpose occurs as soon as the failure occurs, even if the credit agreement allows a period for curing the failure. If one of these defaults has occurred and is continuing on the day when a dividend is otherwise payable on New Century s common stock, we will be unable to pay the dividend unless the lenders on these credit agreements waive the prohibition, or until we cure the default. Failure to pay dividends could also jeopardize our continued qualification as a REIT.

Federal Income Tax Risks and Risks Associated with Being a REIT

We strongly urge you to consult with your own tax advisor concerning the effects of federal, state and local income tax law on an investment in New Century common stock and on your individual tax situation.

If we fail to qualify as a REIT, it could adversely affect our stockholders.

We elected to be taxed as a REIT under the Code commencing with our taxable year ended December 31, 2004. To maintain REIT status, we must meet a number of highly technical requirements on a continuing basis. Those requirements seek to ensure, among other things, (i) that the gross income and investments of a REIT are largely real estate related (including mortgages secured by real estate), (ii) that a REIT distributes substantially all its ordinary taxable income to its stockholders on a current basis and (iii) that the REIT s equity ownership is not overly concentrated. Due to the complex nature of these rules, the available guidance concerning interpretation of the rules, the importance of ongoing factual determinations and the possibility of adverse changes in the law, administrative interpretations of the law and changes in our business, no assurance can be given that we will qualify as a REIT for any particular year. For a summary of these technical requirements, see Material U.S. Federal Income Tax Considerations.

If we fail to qualify as a REIT, we will be taxed as a regular corporation, and distributions to our stockholders will not be deductible in computing our taxable income. The resulting corporate income tax liabilities could materially reduce the distributable cash flow to our stockholders and funds available for reinvestment. Moreover, we might not be able to elect to be treated as a REIT for the next four taxable years after the year during which we ceased to qualify as a REIT. In addition, if we later re-qualified as a REIT, we might be required to pay a full corporate-level tax on any unrealized gains in our assets as of the date of re-qualification and to make distributions to our stockholders equal to any earnings accumulated during the period of non-REIT status. If we do not maintain our status as a REIT, we will not be required to make distributions to our stockholders.

REIT distribution requirements could adversely affect our stockholders.

To maintain our qualification as a REIT under the Code, we must annually distribute to our stockholders at least 90% of our REIT taxable income, exclusive of the income of our taxable REIT subsidiaries and excluding the dividends paid deduction and our net capital gains, if any. This requirement limits our ability to accumulate capital. We may not have sufficient cash or other liquid assets to meet the distribution requirements. Difficulties in meeting the distribution requirements might arise due to competing demands for our funds or to timing differences between tax reporting and cash receipts and disbursements, because income may have to be reported before cash is received, because expenses may have to be paid before a deduction is allowed or because deductions may be disallowed or limited, or the IRS may make a determination that adjusts reported income. In those situations, we might be required to borrow funds on adverse terms in order to meet the distribution requirements and interest and penalties could apply. If we fail to make a required distribution, we would cease to be taxed as a REIT.

Complying with REIT requirements may cause us to forego otherwise attractive opportunities, including certain acquisitions.

In order to qualify as a REIT for U.S. federal income tax purposes, we must satisfy tests concerning, among other things, our sources of income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may cause us to forego opportunities, including certain acquisitions, we would otherwise pursue.

The tax imposed on REITs engaging in prohibited transactions will limit our ability to engage in transactions, including certain methods of securitizing mortgage loans, that would be treated as sales for federal income tax purposes.

A REIT s net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property but including any mortgage loans held in inventory primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were, at the REIT level, to sell a mortgage loan or securitize the loans in a manner

that was treated as a sale of such inventory for federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose not to engage in certain sales of mortgage loans other than through our taxable REIT subsidiaries and may limit the structures we utilize for our securitization transactions even though such sales or structures might otherwise be beneficial for us. In addition, this prohibition may limit our ability to restructure our portfolio of mortgage loans from time to time even if we believe it would be in our best interest to do so.

We will incur excess inclusion income that will increase the tax liability of our stockholders.

Excess inclusion income that is allocated to our tax-exempt stockholders will be fully taxable as unrelated business taxable income under Section 512 of the Code. If a stockholder is foreign, it generally will be subject to U.S. federal income tax withholding on the excess inclusion income without reduction pursuant to any otherwise applicable income tax treaty. U.S. stockholders will not be able to offset such income with net operating losses.

Excess inclusion income is generated when we issue debt obligations with two or more maturities and the terms of the payments on these obligations bear a relationship to the payments that we received on our mortgage loans or mortgage-backed securities securing those debt obligations. Since electing to be taxed as a REIT, we have engaged in non-REMIC CMO securitizations. These CMO securitizations have been structured so that these borrowings will give rise to excess inclusion income, and it is probable that future CMO securitizations will be structured in a similar manner. We may also enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. Excess inclusion income could also result if we were to hold a residual interest in a REMIC. Finally, we may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments. The amount of excess inclusion income in any given year from these activities, transactions and investments could be significant.

Even if we continue to qualify as a REIT, the income earned by our taxable REIT subsidiaries will be subject to federal income tax and we could be subject to an excise tax on non-arm s-length transactions with our taxable REIT subsidiaries.

Our taxable REIT subsidiaries, including New Century TRS and its subsidiaries, expect to earn income from activities that are prohibited for REITs, and will owe income taxes on the taxable income from these activities. For example, we expect that New Century TRS and its subsidiaries will earn income from our mortgage loan origination and sales activities, as well as from other origination and servicing functions, which would generally not be qualifying income for purposes of the gross income tests applicable to REITs or might otherwise be subject to adverse tax liability if the income were generated by a REIT. New Century TRS and its subsidiaries will be taxable as C corporations and will be subject to federal, state and local income tax at the applicable corporate rates on their taxable income, notwithstanding our qualification as a REIT.

In the event that any transactions between us and New Century TRS and its subsidiaries are not conducted on an arm s-length basis, we could be subject to an excise tax on certain amounts from such transactions. We believe that all such transactions will be conducted on an arm s-length basis, but there can be no assurance that the IRS will not successfully contest the arm s-length nature of such transactions or that we will otherwise be able to avoid application of the excise tax varying in an amount equal to 20% to 100% of the gross adjustment to the taxable portion of the intercompany transaction depending on the character of the income or expense event. Any such tax could affect our overall profitability and the amounts of distributions to our stockholders.

We may, at some point in the future, borrow funds from one or more of our corporate subsidiaries. Although any such intercompany borrowings will be structured so as to constitute indebtedness for all tax purposes, no assurance can be given that the IRS will not challenge such arrangements, in which case the borrowing may be re-characterized as a dividend distribution to us by our subsidiary. Any such re-characterization may cause us to fail one or more of the REIT requirements.

We may be harmed by changes in tax laws applicable to REITs, or the reduced 15% tax rate on certain corporate dividends.

Changes to the laws and regulations affecting us, including changes to securities laws and changes to the Code applicable to the taxation of REITs may harm our business. New legislation may be enacted into law or new interpretations, rulings or regulations could be adopted, any of which could harm us and our stockholders, potentially with retroactive effect.

Generally, dividends paid by REITs are not eligible for the 15% U.S. federal income tax rate on certain corporate dividends, with certain exceptions. The more favorable treatment of regular corporate dividends could cause domestic non-corporate investors to consider stocks of other corporations that pay dividends as more attractive than stocks of REITs. It is not possible to predict whether the reduced 15% tax rate on certain corporate dividends will affect the market price of our common stock or what the effect will be.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our executive, administrative and some of our lending offices are located in Irvine, California and consist of approximately 487,760 square feet. The twelve leases covering the executive, administrative and lending offices expire at various points in time from May 2006 to August 2010 and the combined monthly rent for all twelve leases is $849,698. In addition, we have entered into an agreement to lease 190,000 square feet for a new corporate headquarters at 3161 Michelson Drive in Irvine commencing in 2007. We lease space for our origination platform acquired from RBC Mortgage in Houston, Texas consisting of two leases totaling 97,800 square feet with a monthly aggregate base rental of approximately $250,853. Both leases expire in August 2006. We lease space for our regional operating centers in Phoenix, AZ; Scottsdale, AZ; San Diego, CA; Campbell, CA; Sacramento, CA; San Ramon, CA; Woodland Hills, CA; Englewood, CO; Greenwood Village, CO; Miami Lakes, FL; Tampa, FL; Atlanta, GA; Honolulu, HI; Itasca, IL; Foxboro, MA; Woburn, MA; Bloomington, MN; Omaha, NE; Melville, NY; Pearl River, NY; Columbus, OH; Westerville, OH; Plymouth Meeting, PA; Hurst, TX; Plano, TX; Reston, VA; and Bellevue, WA. As of December 31, 2005, these facilities had a monthly aggregate base rental of approximately $884,311. We also lease space for our sales offices, which range in size from 100 to 15,400 square feet (average size is 2,500-3,500 square feet) with lease terms typically ranging from month-to-month to five years. As of December 31, 2005, annual base rents for the sales offices ranged from approximately $4,500 to $413,000. In general, the terms of these leases expire at various points in time between January 2006 and March 2011. We are currently in the process of evaluating our portfolio to consolidate properties where feasible and cost effective.

Item 3. ***Legal Proceedings***

Overman. In September 2002, Robert E. Overman and Martin Lemp filed a class action complaint in the Superior Court of Alameda County, California, against New Century Financial Corporation and New Century Mortgage (collectively, the New Century Entities), U.S. Bancorp, Loan Management Services, Inc., and certain individuals affiliated with Loan Management Services. The complaint alleges violations of the California Consumers Legal Remedies Act, Unfair, Unlawful and Deceptive Business and Advertising Practices in violation of Business & Professions Code Sections 17200 and 17500, Fraud-Misrepresentation and Concealment and Constructive Trust/ Breach of Fiduciary Duty and damages including restitution, compensatory and punitive damages, and attorneys fees and costs. The New Century Entities filed a Section 128.7 sanctions motion seeking dismissal of the case. On December 8, 2003, the court granted the motion for sanctions against the plaintiffs for filing a first amended complaint with allegations against the New Century Entities that were devoid of evidentiary support and ordered the claims stricken without prejudice. On January 27, 2004, the court entered a judgment of dismissal without prejudice in favor of the New Century Entities. The plaintiffs filed a notice of appeal on February 20, 2004 from the judgment entered in favor of the New Century Entities and the order granting the New Century Entities motion for sanctions. The plaintiffs also filed a motion with the appellate court to consolidate this appeal with three additional appeals sought in similar cases against other lenders. On May 28, 2004, the court denied the motion. On June 10, 2005, the

court of appeals dismissed plaintiff s appeal for lack of appellate jurisdiction. On August 10, 2005, the court entered an order holding that the New Century Entities should recover their costs.

England. In April 2003, two former, short-term employees, Kimberly A. England and Gregory M. Foshee, filed a complaint seeking class action status against the New Century Entities, Worth Funding Incorporated (now known as New Century Credit Corporation) (Worth) and The Anyloan Company (now known as Home123 Corporation) (Anyloan). The action was removed on May 12, 2003 from the 19th Judicial District Court, Parish of East Baton Rouge, State of Louisiana to the U.S. District Court for the Middle District of Louisiana in response to the New Century Entities, Worth and Anyloan s Petition for Removal. The complaint alleges failure to pay overtime wages in violation of the federal Fair Labor Standards Act, or FLSA. The plaintiffs filed an additional action in Louisiana state court (19th Judicial District Court, Parish of East Baton Rouge) on September 18, 2003, adding James Gray as a plaintiff and seeking unpaid wages under state law, with no class claims. This second action was removed on October 3, 2003 to the U.S. District Court for the Middle District of Louisiana, and was ordered consolidated with the first action. In April 2004, the U.S. District Court unilaterally de-consolidated the James Gray individual action. In September 2003, the plaintiffs also filed a motion to dismiss their claims in Louisiana to enable them to join in a subsequently filed case in Minnesota entitled *Klas vs. New Century Financial Corporation, et al*. The New Century Entities, Worth and Anyloan opposed the motion and the court agreed with their position and refused to dismiss the plaintiffs case, as it was filed first. The Klas case was consolidated with this case and discovery is proceeding. The New Century Entities, Worth and Anyloan filed a motion to dismiss Worth and Anyloan as defendants. The court granted the motion to dismiss in April 2004. On June 28, 2004, the New Century Entities filed a motion to reject conditional certification of a collective action. The New Century Entities motion to reject the class was granted on June 30, 2005. The plaintiffs had 30 days to file individual actions against the New Century Entities, and approximately 450 actions were filed. Settlement discussions commenced at mediation in January 2006 are ongoing.

Lum. In December 2003, New Century Mortgage was served with a class action complaint filed by Elaine Lum in the Supreme Court of the State of New York in Riverhead, Suffolk County. The complaint alleged that certain payments New Century Mortgage makes to mortgage brokers, sometimes referred to as yield spread premiums, interfered with the contractual relationship between Ms. Lum and her broker. The complaint also sought damages related thereto for fraud, wrongful inducement/breach of fiduciary duty, violation of deceptive acts and practices, unjust enrichment and commercial bribing. The complaint sought class certification for similarly situated borrowers in the State of New York. New Century Mortgage filed a motion to dismiss on January 30, 2004. The judge granted New Century Mortgage s motion and dismissed all claims on March 23, 2004. On April 12, 2004, the plaintiff filed a notice of appeal, seeking review of the court s order granting the motion to dismiss. On June 20, 2005, the Appellate Division of the Supreme Court of the State of New York located in Brooklyn, New York, affirmed the order granting New Century Mortgage s motion to dismiss the complaint. Plaintiff/appellant filed a motion with the appellate division for reargument and/or for leave to appeal to the Court of Appeals, which the Court denied in October 2005. In February 2006, the Court of Appeals denied plaintiff/appellant s motion for leave to appeal and affirmed the Supreme Court s previous ruling, granting New Century Mortgage s motion to dismiss the complaint.

DOL Investigation. On August 2, 2004, the U.S. Department of Labor, Wage and Hour Division, or DOL, informed New Century Mortgage that it is conducting an investigation to determine whether New Century Mortgage is in compliance with the FLSA. The DOL has narrowed the scope of its investigation. New Century Mortgage believes it is in compliance with the FLSA and that it properly pays overtime wages. In April 2005, New Century Mortgage provided requested documents and awaits a response from the DOL.

Rubio. In March 2005, Daniel J. Rubio, a former employee of New Century Mortgage filed a class action complaint against New Century Mortgage in the Superior Court of Orange County, California. The complaint alleges failure to pay overtime wages, failure to provide meal and rest periods, and that New Century Mortgage engaged in unfair business practices in violation of the California Labor Code. The complaint seeks recovery of unpaid wages, interest, and attorneys fees and costs. New Century Mortgage filed a motion to strike and demurrer to the complaint in May 2005. On July 8, 2005, the court overruled the demurrer and granted the motion to strike. The amended complaint was filed in July 2005 and New Century

Mortgage filed its answer in August 2005. In December 2005, New Century Mortgage filed a motion to strike portions of the complaint, which was granted in New Century Mortgage s favor.

Bonner. In April 2005, Perrie Bonner and Darrell Bruce filed a class action lawsuit against New Century Mortgage and Home123 Corporation (Home123) in the U.S. District Court, Northern District of Indiana, Hammond Division alleging violations of the Fair Credit Reporting Act, or FCRA, claiming that New Century Mortgage and Home123 accessed consumer credit reports without authorization because the prescreened offers of credit did not qualify as firm offers of credit. The proposed class consists of all persons in Indiana, Illinois and Wisconsin who received the prescreened offers from April 20, 2003 to May 10, 2005. New Century Mortgage and Home 123 filed their answer to the complaint on June 30, 2005. In September 2005, plaintiffs filed a motion for class certification and on November 1, 2005, New Century Mortgage and Home123 filed a motion for judgment on the pleadings.

Phillips. In July 2005, Pamela Phillips filed a class action lawsuit against the New Century Entities and Home123 in the District Court, Central District of California. Plaintiff alleges violations of FCRA, claiming that the New Century Entities and Home123 accessed consumer credit reports without authorization because the prescreened offers of credit did not qualify as firm offers of credit. The case also alleges that certain disclosures were not made in a clear and conspicuous manner. The proposed class consists of all persons nationwide whose consumer reports were obtained or used by the New Century Entities in connection with a credit transaction not initiated by the consumer and who did not receive a firm offer of credit from the New Century Entities. A proposed sub-class consists of all persons whose consumer reports were obtained or used by the New Century Entities in connection with a credit transaction not initiated by them, and who received a written solicitation to enter a credit transaction which did not provide clear and conspicuous disclosures as required by 15 U.S.C. section 1681m(d). The complaint seeks damages of not more than $1,000 for each alleged violation, declaratory relief, injunctive relief, attorneys fees and costs. The New Century Entities and Home123 filed a motion to dismiss certain claims in October 2005. In November 2005, the Court granted the motion to dismiss these claims. In early March 2006, the court, on its motion, reversed its prior ruling on the motion to dismiss citing the 7th Circuit Court of Appeals recent decision in the *Murray v. GMAC Mortgage Corporation* case.

Jeppesen. In October 2005, Patricia and Stephen Jeppesen filed a class action lawsuit against New Century Mortgage in the U.S. District Court, Northern District Of Indiana. The plaintiffs allege that New Century Mortgage violated the Indiana High Cost Loan Act by allegedly making loans with fees greater than permitted by law unless certain disclosures are made. The class is defined as all persons who obtained a mortgage loan from New Century Mortgage after January 1, 2005 on their principal residence in Indiana. A second claim in the complaint alleges that New Century Mortgage improperly charged a document preparation fee. The class also includes all persons in Indiana who paid a document preparation fee to New Century Mortgage in the six years prior to the filing of the complaint. The complaint seeks statutory damages, attorneys fees, costs, restitution and other relief. In December 2005, New Century Mortgage filed its answer and affirmative defenses and plaintiffs subsequently filed a motion to strike certain affirmative defenses.

Forrest. In January 2006, Mary Forrest filed a class action lawsuit against New Century Mortgage in the U.S. District Court for the Eastern District of Wisconsin, Milwaukee Division. The plaintiff alleges violations of FCRA, claiming that the originator accessed prescreened credit reports without authorization because the offers of credit allegedly did not qualify as firm offers of credit. The proposed class consists of persons with Wisconsin addresses to whom the originator sent a particular prescreened offer of credit after November 20, 2004. In February 2006, New Century Mortgage filed both its answer and a motion to transfer the case to the U.S. District Court for the Central District of California.

We are also a party to various legal proceedings arising out of the ordinary course of our business. Management believes that any liability with respect to these legal actions, individually or in the aggregate, will not have a material adverse effect on our business, results of operations or financial position.

Item 4. ***Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of our stockholders during the fourth quarter of 2005.

PART II

Item 5. *Market for the Registrant s Common Equity and Related Stockholder Matters*

New Century common stock has traded on the NYSE under the symbol NEW since October 1, 2004. Prior to October 1, 2004, the common stock of New Century TRS was quoted on the Nasdaq National Market under the symbol NCEN . New Century TRS common stock is no longer listed on any national securities exchange or quoted on any over-the-counter market. The dividends paid and the high and low sales prices of New Century common stock and, for the period prior to October 1, 2004, the common stock of New Century TRS, during each quarter for the years 2005 and 2004 were as follows:

	2005			2004		
Quarter	**High**	**Low**	**Dividend Per Share**	**High**	**Low**	**Dividend Per Share**
Fourth	$ 40.70	30.22	1.65	$ 66.95	50.95	0.23
Third	53.55	34.50	1.60	63.30	43.27	0.20
Second	54.00	41.45	1.55	50.76	38.50	0.20
First	64.38	43.99	1.50	52.28	37.91	0.16

As of March 10, 2006, the closing sales price of New Century common stock, as reported on the NYSE, was $39.65.

We paid a cash dividend on New Century common stock of $1.70 per share on January 30, 2006 to holders of record of New Century common stock on December 30, 2005. On March 1, 2006, our board of directors declared a cash dividend on New Century common stock of $1.75 per share payable on April 28, 2006 to holders of record of New Century common stock on March 31, 2006. The declaration of any future dividends will be subject to our earnings, financial position, capital requirements, contractual restrictions and other relevant factors.

In order to maintain our qualification as a REIT under the Code, we are required to distribute (within a certain period after the end of each year) at least 90% of our REIT taxable income for such year (determined without regard to the dividends paid deduction and by excluding net capital gain). After-tax earnings generated by our taxable REIT subsidiaries (including New Century TRS) and not distributed to us are not subject to these distribution requirements and may be retained by such subsidiaries to provide for future growth, subject to the limitations imposed by REIT tax rules. To the extent that we do not distribute 100% of our REIT taxable income, we will be taxed on any undistributed amounts. In addition, we cannot assure you that we will have access to funds to meet the distribution and other REIT qualification requirements. We anticipate paying quarterly distributions during January, April, July and October of each year for the preceding quarter. We anticipate that distributions generally will be paid from cash available for distribution (generally equal to cash from operations and investing activities less capital expenditures and principal amortization on indebtedness). However, to the extent that cash available for distribution is insufficient to make such distributions, we intend to borrow funds from one of our subsidiaries or a third party in order to make distributions consistent with this policy. We cannot assure you as to the amount, if any, of future distributions.

As of March 10, 2006, the number of holders of record of New Century common stock was approximately 165.

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The following table shows Company repurchases of its common stock for each calendar month during the quarter ended December 31, 2005:

Calendar Month	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program(1)	Maximum Number of Shares That May Yet Be Purchased Under the Plan or Program(1)
October		$		5,000,000
November	879,200	$ 33.52	879,200	4,120,800
December		$		4,120,800
Total	879,200	$ 33.52	879,200	4,120,800

(1) On November 3, 2005, we publicly announced that our board of directors had approved a stock repurchase program for up to 5 million shares of our common stock over the following 12 months.

Recent Sales of Unregistered Securities

None.

Equity Compensation Plan Information

Information regarding our equity compensation plans, including both stockholder approved plans and non-stockholder approved plans, is included in Item 12.

Item 6. ***Selected Financial Data***

The following selected consolidated statements of income and balance sheet data for the years ended December 31, 2005, 2004, 2003, 2002 and 2001 have been derived from our financial statements. This information has been prepared on the same basis as the audited consolidated financial statements contained elsewhere in this report. Such selected financial data should be read in conjunction with those financial

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statements and the notes thereto and with Management s Discussion and Analysis of Financial Condition and Results of Operations also included elsewhere herein.

	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(Dollars in thousands, except per share data)				
Statement of income data:					
Interest income	$ 1,759,567	898,647	353,691	154,054	99,062
Interest expense	(988,123)	(367,094)	(117,575)	(50,588)	(54,127)
Net interest income	771,444	531,553	236,116	103,466	44,935
Provision for losses on mortgage loans held for investment	(140,233)	(70,250)	(26,304)		
Net interest income after provision for losses	631,211	461,303	209,812	103,466	44,935
Other operating income:					
Gain on sale of mortgage loans	622,617	800,609	611,136	451,744	182,612
Servicing income	38,514	28,896	11,139	432	10,616
Other income	22,400	4,415		16	1,046
Total other operating income	683,531	833,920	622,275	452,192	194,274
Other operating expenses	871,365	684,082	408,835	249,322	155,725
Earnings before income taxes	443,377	611,141	423,252	306,336	83,484
Income taxes	26,834	235,570	177,769	126,636	35,464
Net earnings	$ 416,543	375,571	245,483	179,700	48,020
Basic earnings per share	$ 7.42	10.20	7.26	5.19	1.83
Diluted earnings per share	7.17	8.29	6.32	4.73	1.54
Book value per share(1)	35.94	39.73	16.37	10.92	6.99
Book value per share(2)	35.17	32.90	17.96	10.20	6.70

	As of December 31,				
	2005	2004	2003	2002	2001
	(Dollars in thousands)				
Balance sheet data:					
Cash and cash equivalents	$ 503,723	842,854	278,598	176,669	100,263
Restricted cash	726,697	454,035	116,883	6,255	6,416

Mortgage loans held for sale at lower of cost or market	7,825,175	3,922,865	3,422,211	1,920,396	1,011,122
Mortgage loans held for investment, net	16,143,865	13,195,324	4,745,937		
Residual interests in securitizations	234,930	148,021	179,498	246,964	306,908
Total assets	26,147,090	19,051,944	8,943,938	2,402,928	1,451,318
Credit facilities on mortgage loans held for sale	7,439,685	3,704,268	3,311,837	1,885,498	987,568
Financing on mortgage loans held for investment, net	16,045,459	13,105,973	4,686,323		
Convertible senior notes, net	4,943	5,392	204,858		
Subordinated debt					40,000
Residual financing					79,941
Other liabilities	547,303	357,746	198,909	130,880	96,048
Total stockholders equity	2,109,700	1,878,565	542,011	386,550	247,761

(1) Book value per share is calculated by dividing ending common equity by average basic shares for the most recent quarterly period.

(2) Book value per share is calculated by dividing ending common equity by average diluted shares for the most recent quarterly period.

	For the Years Ended December 31,				
	2005	2004	2003	2002	2001
	(Dollars in thousands)				
Operating Statistics:					
Loan origination and purchase activities:					
Wholesale	$ 49,224,321	38,126,322	25,187,569	12,392,562	5,068,466
Retail	6,883,920	4,073,318	2,195,269	1,808,934	1,176,505
Total loan originations and purchases	$ 56,108,241	42,199,640	27,382,838	14,201,496	6,244,971
Average principal balance per loan	$ 181	174	167	151	138
Percent of loans secured by first mortgages	93.8%	95.9%	98.6%	99.6%	99.3%
Weighted average initial loan-to-value ratio(1)	81.0%	81.1%	80.4%	78.7%	77.8%
Originations by product type:					
ARMs	41,101,125	31,113,241	19,185,517	10,492,558	5,101,783
Fixed-rate mortgages	15,007,116	11,086,399	8,197,321	3,708,938	1,143,188
Weighted average interest rates:					
Fixed-rate mortgages	7.6%	7.3%	7.3%	8.2%	9.5%
ARMs initial rate	7.2%	6.9%	7.3%	8.3%	9.4%
ARMs margin over index	5.8%	5.5%	5.8%	6.6%	6.6%
Secondary Market transactions:					
Loans sold through whole loan transactions	35,314,781	30,329,278	20,835,105	12,419,687	4,723,350
Securitizations structured as sales	6,442,201			845,477	898,244
Total sales	41,756,982	30,329,278	20,835,105	13,265,164	5,621,594
Securitizations structured as financings	10,961,658	10,111,131	4,946,781		
Total secondary market transactions	$ 52,718,640	40,440,409	25,781,886	13,265,164	5,621,594

(1) Weighted average LTV is the LTV of the first lien mortgages and the combined LTV of the second lien mortgages.

Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes contained elsewhere herein. As used herein, except where the context suggests otherwise, for time periods before October 1, 2004, the terms the Company, our, its, we, the group, and us mean New Century TRS Holdings, Inc. and its consolidated subsidiaries, and for time periods on and after October 1, 2004, the terms the Company, our, its, we, the group, and us refer to New Century Fi Corporation and its consolidated subsidiaries.

General

New Century Financial Corporation is a real estate investment trust, or REIT, that, through its taxable REIT subsidiaries, operates one of the nation s largest mortgage finance companies. We began originating and purchasing loans in 1996, and, in the fourth quarter of 2004, we began operating our business as a REIT. We originate and purchase primarily first mortgage loans nationwide. Historically, we have focused on lending to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage

lenders and loan buyers. In September 2005, we acquired a mortgage origination platform from RBC Mortgage Company, or RBC Mortgage, that expands our offerings to include conventional mortgage loans, including Alt-A mortgage loans, loans insured by the Federal Housing Administration, or FHA, and loans guaranteed by the Veterans Administration, or VA. A significant portion of the conventional loans, which are generally referred to as conforming loans, we produce qualify for inclusion in guaranteed mortgage securities backed by the Federal National Mortgage Association, or Fannie Mae, or the Federal Home Loan Mortgage Corp., or Freddie Mac. At the same time, some of the conventional loans we produce either have an original loan amount in excess of the Fannie Mae and Freddie Mac loan limit for single-family loans or otherwise do not meet Fannie Mae or Freddie Mac guidelines.

We have historically sold our loans through both whole loan sales and securitizations structured as sales. Since 2003, we have also retained a portion of our loan production for investment on our balance sheet through securitizations structured as financings rather than sales. Our decisions regarding secondary marketing transactions in 2006 will be affected by market conditions and our ability to access external sources of capital. We do not currently intend to structure any securitizations as sales in 2006.

On April 5, 2004, the board of directors of New Century TRS Holdings, Inc., or New Century TRS, formerly known as New Century Financial Corporation, approved a plan to change its capital structure to enable it to qualify as a REIT for U.S. federal income tax purposes. On April 12, 2004, New Century TRS formed New Century Financial Corporation, or New Century, a Maryland corporation formerly known as New Century REIT, Inc.

Pursuant to the merger that implemented the restructuring of New Century TRS in order for it to qualify as a REIT, New Century became the publicly-traded parent listed on the New York Stock Exchange, or NYSE, that succeeded to and continued to operate substantially all of the existing businesses of New Century TRS and its subsidiaries.

As a result of the merger and the related capital-raising activities, a significant source of our revenue is, and we expect will continue to be, interest income generated from our portfolio of mortgage loans held by our REIT and our qualified REIT subsidiaries. We also expect to continue to generate revenue through our taxable REIT subsidiaries from the sale of loans, servicing income and loan origination fees. We expect the primary components of our expenses to be (i) interest expense on our credit facilities, securitizations, and other borrowings, (ii) general and administrative expenses, and (iii) payroll and related expenses arising from our origination and servicing businesses.

Acquisition of RBC Mortgage Loan Origination Platform

During the third quarter of 2005, Home123 Corporation, one of our wholly owned subsidiaries, purchased the origination platform of RBC Mortgage, which has enabled us to expand our mortgage product offerings, our retail presence on a nationwide basis and our channels of distribution, particularly into the realtor and builder channels. Additionally, we believe that offering a broader range of mortgage products allows us to build upon the success of our national Home123 branding and marketing campaign.

The recently acquired RBC Mortgage origination platform, which is more heavily weighted towards purchase financing as opposed to refinancing transactions, includes approximately 140 branches nationwide and originates residential mortgage loans, consisting primarily of Alt-A, jumbo and conforming mortgages, as well as home equity lines of credit.

The following discussion of the results of operations includes the origination platform we acquired from RBC Mortgage in September 2005. Where the detailed results are discussed, recently acquired operations refer to the operations of the origination platform acquired from RBC Mortgage and historical operations refer to the operations of New Century that existed prior to the RBC Mortgage transaction.

Executive Summary

During 2005, we deployed the capital we raised in 2004 and 2005 by building our REIT portfolio while also growing the profitability of the origination operations of our taxable REIT subsidiaries. During this

period, our industry experienced significant narrowing of margins as most originators kept the interest rates offered to customers at historically low levels while the underlying LIBOR indexes that determine our financing costs continued to rise. As a result, our whole loan sale pricing and the execution for securitizations structured as financings and sales deteriorated relative to 2004.

In the latter part of 2005, we began to increase our interest rates to keep pace with, or exceed, the growth in underlying rates. We intend to continue this approach with a view toward preserving or expanding our overall operating margin. We also are striving to manage our cost structure to remain efficient even if loan origination volume declines. We continue to focus on maximizing the net execution of our whole loan sales and our cost-cutting strategies.

The other major development in our business in recent months has been the completion of our acquisition of the origination platform of RBC Mortgage. This acquisition expands our loan origination channel and product mix. We are concentrating significant efforts on a successful integration that we expect will ultimately allow us to offer a wider range of products to all of our customers and add strong builder and realtor relationships to our loan origination business.

Overview

Our two key business components are: (i) our mortgage loan portfolio held by our REIT and our taxable REIT subsidiaries; and (ii) our origination sales, and servicing activities conducted through certain of our taxable REIT subsidiaries.

REIT and TRS Mortgage Loan Portfolios

The largest component of our revenue is derived from the income we earn on our portfolio of mortgage loans held for investment, which totaled $16.1 billion at December 31, 2005.

During 2003, we shifted our strategy in an effort to address the cyclical nature of our earnings with the goal of generating a more stable long-term earnings stream. Our principal strategy to achieve this goal is to hold loans on our balance sheet. Because our credit facilities are short-term in nature and generally do not allow loans to be financed through the facility for longer than 180 days, a securitization structure offers the most attractive means to finance loans on our balance sheet. To support the goal of matching the timing of cash flows with the recognition of earnings on our loans, we began to structure our securitizations as financings during 2003. During the years ended 2005 and 2004, we completed four securitizations totaling $11.0 billion and five securitizations totaling $10.1 billion, respectively, which were structured as on balance sheet financings. In a securitization structured as a financing, we make an initial cash investment so that the securitization trusts begin to return cash flow to us in the first month following securitization. Therefore, we require cash and capital to make the initial investment, as well as to support the loans on our balance sheet. During 2003, 2004 and 2005, we retained between 20% and 25% of our total loan production through securitizations for investment on our balance sheet.

Our portfolio of mortgage loans held for investment generally consists of a representative cross-section of our overall loan production volume. This portfolio earns net interest income over its life, which is generally two to three years, on a weighted-average basis. The net interest income we earn from our portfolio is influenced by a variety of factors, including the performance of the loans and the level and direction of interest rates.

We measure the performance of the loans by monitoring prepayment rates and credit losses. Faster prepayments reduce the weighted average life of the portfolio, reducing net interest income. Cumulative credit losses, which we generally assume to be approximately 2.5% of the original balance of the loans, also reduce net interest income.

Generally, our loans have a fixed-rate for a period of time, while the underlying bonds that finance those loans are variable-rate based on one-month LIBOR, resulting in interest rate risk. Our hedging strategies to mitigate this interest rate risk are designed to reduce variability in our interest margin over the period of each securitization.

Originations and Sales

The second major component of our business is our ability to originate and purchase mortgage loans at a reasonable cost and to sell a portion of those loans in the secondary mortgage market. For the past several years, our secondary marketing strategy has included a combination of both whole loan sales and securitizations of our loans.

Loan origination volumes in our industry have historically fluctuated from year to year and are affected by such external factors as home values, the level of interest rates and consumer debt and the overall condition of the economy, among others. In addition, the premiums we receive from the secondary market for our loans also have fluctuated and are influenced by each of these factors, but predominantly the interest rate environment. As a consequence, the business of originating and selling loans is cyclical. In light of our current strategy to raise interest rates, our loan production volume may decrease as a result of these higher interest rates on the mortgages we originate.

The operating margin of our origination franchise has three components: (i) net interest income, (ii) gain on sale of mortgage loans, and (iii) loan origination or acquisition costs. We use the operating margin as our principal metric to measure the value of our origination franchise.

Net interest income on mortgage loans held for sale We typically hold our mortgage loans held for sale for an average period of 30 to 50 days before they are sold in the secondary market or securitized. During that time, we earn the coupon rate of interest paid by the borrower, and we pay interest to the lenders that provide our financing facilities. During 2004, the difference between these interest rates was approximately 4.5%. During 2005, this margin decreased to 2.7% as short-term rates increased more rapidly than our average coupon rates. We seek to manage the timing of our sales to enhance the net interest income we earn on the loans, while preserving the ability to sell the loans at the maximum price.

Gain on sale of mortgage loans Gain on sale of mortgage loans is affected by the condition of the secondary market for our loans. During the latter half of 2004 and all of 2005, as interest rates began to rise, the underlying factors that affect secondary market pricing remained somewhat stable. However, as short-term rates rose faster than long-term rates (a flatter yield curve), the prices we received for our loans began to decline relative to historic levels. Further, as a result of competitive pressures, we did not previously raise the interest rates we charged our borrowers to the degree that underlying short-term rates increased, reducing gain on sale margins in 2005 compared to 2004. More recently, we have taken steps to strategically increase our rates in an effort to improve our operating margins. We believe that the positive impact of these steps will improve our gain on sale margins in the first and second quarters of 2006.

Loan origination or acquisition cost We also monitor the cost to originate our loans. We typically refer to this as our loan acquisition costs. Loan acquisition costs are comprised of the following: fees paid to wholesale brokers and correspondents, plus direct loan origination costs, including commissions and corporate overhead costs less points and fees received from borrowers, divided by total loan production volume. Loan acquisition costs do not include profit-based compensation, servicing division overhead, parent company expenses or startup operations. During 2004 and through the first quarter of 2005, our loan acquisition costs remained relatively stable and generally fluctuated inversely with our loan production volume. As a result of the competitive environment and its impact on the value of our loans, in 2005 we began implementing cost-cutting measures designed to reduce our loan acquisition costs. The cost-cutting measures we implemented in the first quarter of 2005, which included changes to our sales compensation, controlling growth in non-sales overhead and more closely scrutinizing our discretionary spending, together with an increase in our loan production, resulted in a significant reduction of our loan acquisition costs during the latter part of 2005.

These two components of our business account for most of our operating revenues and expenses. Our origination platform provides the source of the loan volume to conduct both parts of our business.

In addition, during the fourth quarter of 2005, we closed $2.5 billion in loans through the origination platform recently acquired from RBC Mortgage and acted as a broker for an additional $382.8 million to third parties. As we previously expected, these operations negatively impacted our net income in 2005, including certain integration costs. While the loss was modestly greater than anticipated, we expect that the origination

platform will be profitable in 2006. The mortgage loans originated by our recently acquired operations consist primarily of Alt-A, jumbo and conforming and home equity lines of credit products that are sourced through retail and wholesale channels as well as with limited liability partnerships with builder/realtors. We sell the majority of our mortgage loans originated through these operations in the whole loan market.

Loan originations and purchases

Historically, we have focused on lending to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers. In connection with our recently acquired loan origination platform acquired from RBC Mortgage we also originate Alt-A, jumbo and conforming mortgages, as well as home equity lines of credit.

As of December 31, 2005, our Wholesale Division operated through 35 regional operating centers and originated or purchased $49.2 billion in loans during the year ended December 31, 2005. Our Retail Division originated loans through 222 sales offices, including our centralized telemarketing unit and our builder/realtor channel, and originated $6.9 billion in loans during the year ended December 31, 2005.

As of December 31, 2004, our Wholesale Division operated through 26 regional operating centers. Our Wholesale Division originated or purchased $38.1 billion in loans during the year ended December 31, 2004. As of December 31, 2004, our Retail Division originated loans through 74 sales offices, including our centralized telemarketing unit. Our Retail Division originated $4.1 billion in loans during the year ended December 31, 2004.

For the year ended December 31, 2005, approximately $27.1 billion, or 48.4%, of our mortgage production consisted of cash-out refinancings, transactions in which the borrowers refinanced their existing mortgages and received cash representing a portion of the equity in their homes. For the same period, approximately $23.6 billion, or 42.0%, of our mortgage production consisted of home purchase finance loans. The remainder of our mortgage production, $5.4 billion, or 9.6%, consisted of transactions in which borrowers refinanced their existing mortgages to obtain a better interest rate or loan maturity, or rate and term refinance transactions. For the year ended December 31, 2004, total originations consisted of $25.1 billion, or 59.5%, of cash-out refinancings, $14.9 billion, or 35.3%, of home purchase financings, and $2.2 billion, or 5.2%, of rate and term refinance transactions. Market and economic conditions, as well as our focus on increasing our home purchase business, have shifted our product mix, resulting in a greater percentage of home purchase financings as compared to cash-out refinancings. We believe that our current product mix is sustainable and that our origination strategies and initiatives are consistent with that belief. If we are successful in maintaining this mix, we believe our exposure to interest rate cyclicality will be reduced.

We have experienced considerable growth of our interest-only product. During the year ended December 31, 2005, originations of adjustable-rate, interest-only loans totaled $16.6 billion, or 29.6%, of total originations and fixed, interest-only loans totaled $0.7 billion, or 1.2%, of total originations. Interest-only originations during the year ended December 31, 2004 totaled $8.1 billion, or 19.3%, of total originations during the period. We believe our strict underwriting guidelines and the stronger credit characteristics of these loans mitigate their perceived higher risk. In September 2005, we implemented pricing strategies to reduce the volume of our interest-only product to 25% of total loan production to improve secondary market execution and profitability. The strategies include pricing increases, underwriting changes and new product offerings, including a 40-year mortgage product. These changes reduced interest-only production to 22.4% of total loan production for the fourth quarter of 2005. It is important to note, however, that the credit performance of our interest-only product continues to outperform our expectations.

For the year ended December 31, 2005, full documentation loans as a percentage of originations totaled $30.4 billion, or 54.2%, limited documentation loans totaled $1.5 billion, or 2.7%, and stated documentation loans totaled $24.2 billion, or 43.1%. Full documentation loans generally require applicants to submit two written forms of verification of stable income for at least 12 months. Limited documentation loans generally require applicants to submit 12 consecutive monthly bank statements on their individual bank accounts.

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Stated income documentation loans are based upon stated monthly income if the applicant meets certain criteria. For the year ended December 31, 2004, full documentation loans as a percentage of total originations totaled $21.5 billion, or 51.0%, limited documentation loans totaled $2.0 billion, or 4.8%, and stated documentation loans totaled $18.7 billion, or 44.2%. Generally, economic and market conditions, including new product introductions and offerings by competitors, influence product mix. As these factors change, product mix, including the type of documentation required, fluctuates as well. We designed our underwriting standards and quality assurance programs to insure that loan quality is consistent and meets our guidelines, even as the mix among full, limited and stated documentation varies.

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The following table sets forth selected information relating to loan originations and purchases during the periods shown (dollars in thousands):

	For the Years Ended December 31,			
	2005		2004	
	Total	%	Total	%
Wholesale	$ 49,224,321	87.7	38,126,322	90.3
Retail	6,883,920	12.3	4,073,318	9.7
Total originations and purchases	56,108,241	100.0	42,199,640	100.0
Fixed-rate mortgages:				
Traditional	13,845,595	24.6	11,086,399	26.3
Interest-Only	671,824	1.2		
40-Year	489,697	0.9		
Sub-total Fixed	15,007,116	26.7	11,086,399	26.3
Adjustable-rate mortgages:				
Traditional	21,194,109	37.8	22,969,212	54.4
Interest-Only	16,580,514	29.6	8,144,029	19.3
40-Year	3,298,913	5.9		
HELOC	27,589			
Sub-total ARM	41,101,125	73.3	31,113,241	73.7
Total originations and purchases	56,108,241	100.0	42,199,640	100.0
Purchases	23,571,645	42.0	14,880,034	35.3
Refinances:				
Cash-out refinances	27,130,520	48.4	25,121,511	59.5
Rate/term refinances	5,406,076	9.6	2,198,095	5.2
Total originations and purchases	56,108,241	100.0	42,199,640	100.0
Full documentation	30,438,822	54.2	21,530,191	51.0
Limited documentation	1,501,367	2.7	2,014,253	4.8
Stated documentation	24,168,052	43.1	18,655,196	44.2
Total originations and purchases	$ 56,108,241	100.0	42,199,640	100.0
Average principal balance of loans originated and purchased	$ 181		174	
Weighted average FICO score of loans originated and purchased	634		627	
Percent of loans secured by first mortgages	93.8%		93.2%	
Weighted average loan-to-value ratio(1)	81.0%		81.1%	
Weighted average interest rates:				
Fixed-rate mortgages	7.6%		7.3%	
Adjustable-rate mortgages initial rate	7.2%		6.9%	
Adjustable-rate mortgages margin over index	5.8%		5.5%	

Total originations and purchases	7.3%	7.0%
Percentage of loans originated in top two credit grades	84.0%	85.8%
Percentage of loans originated in bottom two credit grades	2.3%	3.2%

(1) Weighted average LTV is the LTV of the first lien mortgages and combined LTV of the second lien mortgages.

Secondary Market Transactions

Historically, one of the major components of revenue has been the recognition of gain on sale of our loans through whole loan sales and securitizations structured as sales. In a whole loan sale, we recognize and receive a cash gain upon the sale of a pool of mortgage loans to third parties. In a securitization structured as a sale for financial reporting purposes, we typically recognize a gain on sale at the time we sell a pool of loans to the trust that will raise the cash portion of the purchase price by selling senior certificates representing senior interests in the pool of loans. We also receive cash flows over the actual life of the loans from the residual interests we retain in the pool of loans after payment of servicing fees, guarantor fees and other trust expenses if the specified over-collateralization requirements are met.

Since the first quarter of 2003, we have structured most of our securitizations as on balance sheet financings rather than sales. Such structures do not result in gain on sale at the time of the transaction, but rather yield interest income as the payments on the underlying mortgages are received. The following table sets forth secondary marketing transactions for the periods indicated (dollars in thousands):

	For the Years Ended December 31,					
	2005		2004		2003	
	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales
Subprime whole loan sales	$ 32,816,911	62.2	30,181,150	74.6	20,587,888	79.8
Prime and Alt-A whole loan sales	2,251,335	4.3				
Securitizations structured as sales	6,442,201	12.2				
Total premium sales	41,510,447	78.7	30,181,150	74.6	20,587,888	79.8
Discounted whole loan sales	246,535	0.5	148,128	0.4	247,217	1.0
Total sales	41,756,982	79.2	30,329,278	75.0	20,835,105	80.8
Securitizations structured as financings	10,961,958	20.8	10,111,131	25.0	4,946,781	19.2
Total secondary market transactions	$ 52,718,940	100.0	40,440,409	100.0	25,781,886	100.0

During 2005, we closed four securitizations structured as sales, which resulted in recognition of gain on sale income and an increase in our residual interests in securitizations. Whole loan sales and securitizations structured as sales provide greater current period earnings compared to investments in securitizations structured as financings, which recognize income over time. Although securitizations structured as sales may provide greater current period earnings compared to whole loan sales, the securitizations generally provide less cash at closing than do whole loan sales.

Loan Sales

During the year ended December 31, 2005, whole loan sales and securitizations structured as sales accounted for $41.8 billion, or 79.2%, of our total secondary market transactions. During 2004, whole loan sales accounted for

$30.3 billion, or 75.0%, of our total secondary market transactions. As short-term interest rates have risen faster than long-term interest rates (a flatter yield curve), the prices we received for our loans began to decline in 2004 relative to historic levels and continued to decline in 2005. Further, during most of 2005, as a result of competitive pressures, we did not raise the interest rates we charged our borrowers to the same degree that short-term rates increased, further reducing margins in the year ended December 31, 2005 compared to the same periods in 2004.

We seek to increase our premiums on whole loan sales by closely monitoring requirements of institutional purchasers and focusing on originating or purchasing the types of loans for which institutional purchasers tend to pay higher premiums. During the year ended December 31, 2005, we sold $6.3 billion of loans to Carrington Capital Management, LLC and $5.8 billion of loans to Morgan Stanley Mortgage Capital, Inc., which

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represented 15.9% and 14.6%, respectively, of total loans sold. While nearly one-third of our loans were sold to these two investors, our loans are sold through a competitive bid process that generally includes many more potential buyers.

Securitizations Structured as Financings

During the year ended December 31, 2005, we completed four securitizations totaling $11.0 billion, structured as financings for accounting purposes under Statement of Financial Accounting Standards No. 140, or SFAS 140. The portfolio-based accounting treatment for securitizations structured as financings and recorded on-balance sheet is designed to more closely match the recognition of income with the receipt of cash payments. Because we do not record gain on sale revenue in the period in which the securitization structured as a financing occurs, the use of such portfolio-based accounting structures will result in lower income in the period in which the securitization occurs than would a securitization structured as a sale. However, the recognition of income as interest payments are received on the underlying mortgage loans is expected to result in higher income recognition in future periods than would a securitization structured as a sale. During the year ended December 31, 2004, we completed five securitizations structured as financings totaling $10.1 billion.

Securitizations Structured as Sales

During the year ended December 31, 2005, we completed four securitizations structured as sales totaling $6.4 billion, resulting in a gain on sale of $141.5 million. During the year ended December 31, 2004, we did not complete any securitization transactions structured as sales, however, we continue to hold residual interests on our balance sheet related to securitizations structured as sales closed in 2002 and prior years. The mortgage servicing rights related to the securitizations structured as sales are sold within 30 to 60 days after securitization. Purchasers of securitization bonds and certificates have no recourse against our other assets, other than the assets of the trust. The value of our retained interests is subject to credit, prepayment and interest rate risk on the transferred financial assets.

At the closing of a securitization structured as a sale, we add to our balance sheet the residual interest retained based on our calculation of the present value of estimated future cash flows that we will receive. The residual interest we record consists of the overcollateralization, or OC, account and the net interest receivable, or NIR. On a combined basis, these are referred to as the residual interests.

On a quarterly basis, we review the underlying assumptions to value each residual interest and adjust the carrying value of the securities based on actual experience and industry trends. To determine the residual asset value, we project the cash flow for each security. To project cash flow, we use base assumptions for the constant prepayment rate, or CPR, and losses for each product type based on historical performance. We update each security to reflect actual performance to date and we adjust base assumptions for CPR and losses based on historical experience to project performance of the security from that date forward. Then, we use the LIBOR forward curve to project future interest rates and compute cash flow projections for each security. Next, we discount the projected cash flows at a rate commensurate with the risk involved. At December 31, 2005, we used discount rates of 12% for residual interests and 14% for residual interests through net interest margin security, or NIMS, transactions.

During the years ended December 31, 2005 and 2004, as a result of our quarterly evaluations of the residual interests, we recorded a $10.0 million decrease, including a hurricane loss provision of $2.6 million, and a $7.7 million decrease in the fair value of the residual assets, respectively. These fair value adjustments represent the change in the estimated present value of future cash flows from the residual interests. Changes in the loss assumptions on certain loans underlying our residual interests, as well as fluctuations in the overall interest rate environment, resulted in a reduction in fair value.

In the first quarter of 2004, we invested $2 million in Carrington Capital Management, LLC, or the LLC, and $25 million in Carrington Mortgage Credit Fund I, LP, or Carrington, which is sponsored by the LLC. Carrington acquires individual and pooled single-family residential subprime loans and securitizes them in transactions structured as sales. We were originally the majority investor in Carrington, requiring us to consolidate Carrington s results in our financial statements for financial reporting purposes through Septem-

ber 30, 2004. In the fourth quarter of 2004, Carrington raised additional capital, reducing our ownership position to approximately 38%. Since that time, we have included Carrington in our financial statements under the equity method of accounting. As a result of Carrington s capital raising activities, our ownership position is approximately 7% as of December 31, 2005. The carrying value of our equity investment in Carrington and the LLC is $39.7 million.

Discounted Loan Sales

During the year ended December 31, 2005, we sold $246.5 million in loans at a discount to their outstanding principal balance. These loans consisted of repurchased loans, loans with documentation defects or loans that whole loan buyers rejected because of certain characteristics. For the year ended December 31, 2004, discounted sales totaled $148.1 million. On a percentage basis, discounted sales increased slightly from 0.5% of total sales in 2004 to 0.6% in 2005. The severity of the discount also increased slightly from 5.8% during 2004 to 6.5% during 2005.

Critical Accounting Policies

We have established various accounting policies that govern the application of accounting principles generally accepted in the United States in the preparation of our financial statements. Certain accounting policies require us to make significant estimates and assumptions that may have a material impact on certain assets and liabilities or our results of operations, and we consider these to be critical accounting policies. The estimates and assumptions we use are based on historical experience and other factors which we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates and assumptions, which could have a material impact on the carrying value of assets and liabilities and our results of operations.

We believe the following are critical accounting policies that require the most significant estimates and assumptions and are subject to significant change in the preparation of our consolidated financial statements. These estimates and assumptions include, but are not limited to, the interest rate environment, the economic environment, secondary market conditions and the performance of the loans underlying our residual assets and mortgage loans held for investment.

Securitizations Structured as Financings

Since January 2003, we have completed a total of 14 securitizations structured as financings under SFAS 140. Such securitizations were collateralized by $26.0 billion of mortgage loans.

These securitizations are structured legally as sales, but for accounting purposes are treated as financings under SFAS 140. The securitization trusts do not meet the qualifying special purpose entity criteria under SFAS 140 and related interpretations, due to their ability to enter into derivative contracts. Additionally, we have the option to purchase loans from the trust at our discretion. Accordingly, the loans, which we refer to as mortgage loans held for investment, remain on our balance sheet, retained interests are not created and financing on mortgage loans held for investment replaces the credit facility debt originally financing the mortgage loans. We record interest income on securitized loans and interest expense on the bonds issued in the securitizations over the life of the securitizations. Deferred debt issuance costs and discount related to the bonds are amortized on a level yield basis over the estimated life of the bonds.

Allowance for Losses on Mortgage Loans Held for Investment

For our mortgage loans held for investment, we establish an allowance for loan losses based on our estimate of losses inherent and probable as of the balance sheet date. We charge off uncollectible loans at the time of liquidation. We evaluate the adequacy of this allowance each quarter, giving consideration to factors such as the current performance of the loans, credit characteristics of the portfolio, the value of the underlying collateral and the general economic environment. In order to estimate an appropriate allowance for losses on loans held for investment, we estimate losses using static pooling, which stratifies the loans held for investment into separately identified vintage pools. Using historic experience and taking into consideration the

factors above, we estimate an allowance for credit losses, which we believe is adequate for known and inherent losses in the portfolio of mortgage loans held for investment. We charge the loss provision to our consolidated statement of income. We charge losses incurred on mortgage loans held for investment to the allowance.

The allowance for losses on mortgage loans held for investment as a percentage of mortgage loans held for investment as of December 31, 2005 was approximately 1.22% of the unpaid principal balance of the loans compared to 0.73% for the same period in the prior year.

Residual Interests and Securitizations Structured as Sales

Residual interests in securitizations are recorded as a result of the sale of loans through securitizations that we structure as sales rather than financings, also referred to as off-balance sheet securitizations. We may also sell residual interests in securitizations through NIMS.

In a securitization structured as a sale, we sell a pool of loans to a trust for cash and a certificate evidencing our residual interest ownership in the trust. The trust raises the cash portion of the purchase price by selling senior certificates representing senior interests in the loans in the trust. Following the securitization, purchasers of senior certificates receive the principal collected, including prepayments, on the loans in the trust. In addition, they receive a portion of the interest on the loans in the trust equal to the specified investor pass-through interest rate on the principal balance. We receive the cash flows from the residual interests after payment of servicing fees, guarantor fees and other trust expenses if the specified over-collateralization requirements are met. Over-collateralization requirements are generally based on a percentage of the original or current unpaid principal balance of the loans and may be increased during the life of the transaction depending upon actual delinquency or loss experience. A NIMS transaction, through which certificates are sold that represent a portion of the spread between the coupon rate on the loans and the investor pass-through rate, may also occur concurrently with or shortly after a securitization. A NIMS transaction allows us to receive a substantial portion of the gain in cash at the closing of the NIMS transaction, rather than over the actual life of the loans.

The Annual Percentage Rate, or APR, on the mortgage loans is relatively high in comparison to the pass-through interest rate on the certificates. Accordingly, the residual interests in securitizations described above are a significant asset. In determining the value of the residual interests in securitizations, we estimate the future rate of prepayments, prepayment penalties that we will receive, delinquencies, defaults and default loss severity as they affect the amount and timing of the estimated cash flows. We estimate average cumulative losses as a percentage of the original principal balance of the mortgage loans of 1.75% to 4.86% for adjustable-rate securities and 1.45% to 5.30% for fixed-rate securities. We base these estimates on historical loss data for the loans, the specific characteristics of the loans, and the general economic environment. While the range of estimated cumulative pool losses is fairly broad, the weighted average cumulative pool loss estimate for the entire portfolio of residual assets was 3.72% at December 31, 2005. We estimate prepayments by evaluating historical prepayment performance of our loans and the impact of current trends. We use a prepayment curve to estimate the prepayment characteristics of the mortgage loans. The rate of increase, duration, severity, and decrease of the curve depends on the age and nature of the mortgage loans, primarily whether the mortgage loans are fixed or adjustable and the interest rate adjustment characteristics of the mortgage loans (6-month, 1-year, 2-year, 3-year, or 5-year adjustment periods). These prepayment curve and default estimates have resulted in weighted average lives of between 2.29 to 2.60 years for our adjustable-rate securities and 2.33 to 3.54 years for our fixed-rate securities.

During the year ended December 31, 2005, we completed four securitizations structured as sales totaling $6.4 billion structured as sales under SFAS 140. The gain on sale recorded for the four securitizations was $141.5 million and our retained interests totaled $97.5 million. During the year ended December 31, 2004, we did not complete any securitizations structured as sales. In this type of securitization, the transferor of financial assets surrenders effective control over those financial assets to the extent that consideration other than beneficial interests in the transferred assets is received in exchange and the trusts meet the qualifying special purpose entity criteria under SFAS 140 and related interpretations. Thus, we are not required to consolidate the trusts.

During the year ended December 31, 2005, residual interests in securitizations provided $17.5 million in net cash flow to us. We perform an evaluation of residual interests in securitizations quarterly, taking into consideration trends in actual cash flow performance, industry and economic developments, as well as other relevant factors. For the year ended December 31, 2005, we increased our prepayment assumptions based on actual performance and made minor adjustments to certain other assumptions, resulting in a $10.0 million downward fair value adjustment, including a hurricane loss provision of $2.6 million, for the year.

The bond and certificate holders and their securitization trusts have no recourse to us for failure of mortgage loan borrowers to pay when due. Our residual interests in securitizations are subordinate to the bonds and certificates until the bond and certificate holders are fully paid.

We are party to various transactions that have an off-balance sheet component. In connection with our off-balance sheet securitization transactions, there were $6.9 billion in loans owned by the off-balance sheet trusts as of December 31, 2005. The trusts have issued bonds secured by these loans. The bondholders generally do not have recourse to us in the event that the loans in the various trusts do not perform as expected except for specific circumstances. Because these trusts are qualifying special purpose entities, in accordance with generally accepted accounting principles, we have included only our residual interest in these loans on our balance sheet. The performance of the loans in the trusts will impact our ability to realize the current estimated fair value of these residual assets.

Allowance for Repurchase Losses

The allowance for repurchase losses on loans sold relates to expenses incurred due to the potential repurchase of loans or indemnification of losses based on alleged violations of representations and warranties that are customary to the business. Generally, repurchases are required within 90 days from the date the loans are sold. Occasionally, we may repurchase loans after 90 days have elapsed. Provisions for losses are charged to gain on sale of loans and credited to the allowance while actual losses are charged to the allowance. In order to estimate an appropriate allowance for repurchase losses we use historic experience, taking into consideration factors such as premiums received on and volume of recent whole loan sales and the general secondary market and general economic environment. As of December 31, 2005 and December 31, 2004, the repurchase allowance totaled $7.0 million and $6.3 million, respectively. Approximately $10.7 billion and $8.3 billion of loans were subject to repurchase, representing loans sold during the fourth quarter of 2005 and the fourth quarter of 2004, respectively. We believe the allowance for repurchase losses is adequate as of December 31, 2005 and 2004.

Gain on Sale of Loans

We recognize gains or losses resulting from sales or securitizations of mortgage loans at the date of settlement based on the difference between the selling price for the loans sold or securitized and the carrying value of the loans sold. Such gains and losses may be increased or decreased by the amount of any servicing-released premiums received. We defer recognition of non-refundable fees and direct costs associated with the origination of mortgage loans until the loans are sold.

We account for loan sales and securitizations as sales when we surrender control of the loans, to the extent that we receive consideration other than beneficial interests in the loans transferred in the exchange. Liabilities and derivatives incurred or obtained by the transfer of loans are required to be measured at fair value, if practicable. Also, we measure servicing assets and other retained interests in the loans by allocating the previous carrying value between the loans sold and the interest retained, if any, based on their relative fair values on the date of transfer.

Income Taxes

Commencing in 2004, we have operated so as to qualify as a REIT for federal income tax purposes and are not generally required to pay federal and most state income taxes if we meet the REIT requirements of the Internal Revenue Code of 1986, as amended, or the Code. Also, our subsidiaries that meet the requirements of the Code to be a qualified REIT subsidiary, or a QRS, are not generally required to pay federal and most state

income taxes. However, we must recognize income taxes in accordance with Statement of Financial Accounting Standards No. 109 Accounting for Income Taxes, or SFAS 109, for our taxable REIT subsidiaries, or TRS, whose income is fully taxable at regular corporate rates.

SFAS 109 requires that deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of the existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Derivative Instruments Designated as Hedges

We account for certain Euro Dollar futures and interest rate cap contracts, designated and documented as hedges pursuant to the requirements of Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities , or SFAS 133. Pursuant to SFAS 133, these contracts have been designated as hedging the exposure to variability of cash flows from our financing on mortgage loans held for investment attributable to changes in interest rates. Cash flow hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a cash flow hedge be reported in other comprehensive income and the ineffective portion be reported in current earnings. Additionally, certain Euro Dollar futures contracts have been designated as hedges of the fair values of certain mortgage loans held for investment and certain mortgage loans held for sale, pursuant to SFAS 133. Fair value hedge accounting requires that for a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability attributable to the hedged risk be reported in current earnings.

Results of Operations

Consolidated net earnings increased to $416.5 million in 2005 from $375.6 million in 2004 and $245.5 million in 2003. Although net earnings increased 10.9% from 2004 to 2005, diluted earnings per share decreased from $8.29 per share in 2004 to $7.17 in 2005 due to an increase in the average number of diluted shares outstanding during the period resulting from our capital raise in the fourth quarter of 2004, when we converted to a REIT.

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The following tables set forth our results of operations as a percentage of total net interest income and other operating income for the periods indicated (dollars in thousands, except per share and share amounts):

	For the Years Ended December 31,		
	2005	2004	2003