NEW CENTURY FINANCIAL CORP
Form 10-Q
August 09, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2005

OR

¨ **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 **(State or other jurisdiction of** **incorporation or organization)**	**56-2451736** **(I.R.S. Employer** **Identification No.)**
18400 VON KARMAN, SUITE 1000, **IRVINE, CALIFORNIA** **(Address of principal executive offices)**	**92612** **(Zip code)**

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

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check ¨ 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 twelve 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 x NO ¨

Indicate by check ¨ whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES x NO ¨

As of July 31, 2005, the registrant had 56,352,490 shares of common stock outstanding.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

FORM 10-Q

QUARTER ENDED JUNE 30, 2005

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Certain information included in this Form 10-Q may include forward-looking statements under federal securities laws, and the company intends that such forward-looking statements be subject to the safe-harbor created thereby. Such statements include, without limitation, (i) the company s expectation that its portfolio of mortgage assets will provide a relatively stable source of revenues and will contribute a significant portion of the company s earnings in 2005; (ii) the company s expectation that it will retain between 20% and 30% of its total loan production for investment on its balance sheet for 2005; (iii) the company s belief that a substantial majority of its loan sales will occur during the second half of 2005; (iv) the company s expectation that its reported earnings in the second half of 2005 will exceed its reported earnings in the first half of 2005; (v) the company s belief that its REIT structure provides the most tax-efficient way to hold mortgage loans on its balance sheet; (vi) the company s expectation that it will continue to increase the size of its on-balance sheet mortgage loan portfolio, producing more diverse revenues across a variety of interest rate environments; (vii) the company s intention to evaluate, from time to time, whether it should engage in various capital raising activities, which may include offerings of debt, preferred stock, common stock or equity-linked securities; (viii) the company s expectation that a significant source of its revenue prospectively will be interest income generated from its portfolio of mortgage loans held by the company s REIT and its qualified REIT subsidiaries; (ix) the company s expectation that it will continue to generate revenue through its taxable REIT subsidiaries from the sale of loans, servicing income and loan origination fees; (x) the company s expectation that the primary components of its expenses will be interest expense on its credit facilities, securitizations and other borrowings, general and administrative expenses and payroll and related expenses arising from the company s origination and servicing businesses; (xi) the company s expectation that a majority of its income will come from the interest it earns on the mortgage assets its holds for investment; (xii) the company s expectation that it will supplement its income with earnings from its taxable REIT subsidiaries, which will continue to originate, service and sell mortgage loans; (xiii) the company s assumptions with respect to cumulative credit losses, which it generally assumes to be approximately 3% of the original balance of the loans; (xiv) the company s expectation that the gain on sale of mortgage loans will remain at lower margins, similar to the margins during the first six months of 2005, through the fourth quarter of 2005; (xv) the company s belief that it may continue to utilize securitizations structured as sales in the second half of 2005 in order to maximize the secondary market value of its loan production; (xvi) the company s belief that its current rate of business is sustainable and that its origination strategies and initiatives are consistent with that belief; (xvii) the company s belief that if it is successful in maintaining its current mix of production, the company s exposure to interest rate cyclicality will be reduced; (xviii) the company s belief that its stricter underwriting guidelines and the stronger credit characteristics of its interest-only loans mitigate their perceived higher risk; (xix) the company s expectation that the recognition of income as interest payments on the underlying mortgage loans will result in higher income recognition in future periods than would a securitization structured as a sale; (xx) the company s belief that Carrington may acquire additional assets (including regular and residual interests, whole loans, participation certificates, grantor trust and trust certificates, warehousing and servicing interests) in either the primary or secondary markets; (xxi) the company s underlying assumptions used to value its residual interests in securitizations and to determine the discount rates of projected cash flows for its residual interests and for residual interests through NIMS transactions; (xxii) the estimates and assumptions required by the company s accounting policies; (xxiii) the company s estimates and assumptions with respect to the interest rate environment; (xxiv) the company s estimates and assumptions with respect to the economic environment; (xxv) the company s estimates and assumptions with respect to secondary market conditions; (xxvi) the company s estimates and assumptions with respect to the performance of the loans underlying its residual assets and mortgage loans held for investment; (xxvii) the company s loan loss allowance estimates; (xxiii) the company s estimates with respect to its average cumulative losses as a percentage of the original principal balance of mortgage loans; (xxix) the company s beliefs with respect to its legal proceedings; (xxx) the company s expectations with respect to the renewal or extension of its credit facilities; (xxxi) the company s expectations regarding its target levels of liquidity and capital; (xxxii) the execution of the company s strategy to effectively manage the percentage of loans sold through whole loan sales compared to securitizations structured as financings; (xxxiii) the company s successful execution of its liquidation strategy; (xxxiv) the company s expectation that its liquidity, credit facilities and capital resources will be sufficient to fund its operations for the foreseeable future, while enabling it to maintain its qualification as a REIT under the requirements of the Code; (xxxv) the company s expectation that it will access the capital markets when appropriate to support its growth plan; (xxxvi) the company s expectation that the RBC transaction will be slightly dilutive to its earnings-per-share in 2005 and accretive to its earnings-per-share within the first 12 months following the transaction s close; (xxxvii) the company s expectation that the RBC transaction will close in the third quarter of 2005; (xxxviii) the belief that the RBC transaction will establish the company as a leader in the retail origination channel; (xxxix) the company s belief that RBC s large purchase business will be significant to growing the company s business; and (xl) the company s belief that being a full-service mortgage provider will allow it to build upon the success of its national Home123 branding and marketing campaign.

The company cautions that these statements are qualified by important factors that could cause its actual results to differ materially from expected results in the forward-looking statements. Such factors include, but are not limited to, (i) the condition of the U.S. economy and financial system; (ii) the interest rate environment; (iii) the effect of increasing competition in the company s sector; (iv) the condition of the markets for whole loans and mortgage-backed securities; (v) the stability of residential property values; (vi) the company s ability to comply with the requirements applicable to REITs; (vii) the company s ability to increase its portfolio income; (viii) the company s ability to continue to maintain low loan acquisition costs; (ix) the potential effect of new state or federal laws and regulations; (x) the company s ability to maintain adequate credit facilities to finance its business; (xi) the outcome of litigation or regulatory actions pending against the company; (xii) the company s ability to adequately hedge its residual values; (xiii) the accuracy of the assumptions regarding the company s repurchase allowance and residual valuations, prepayment speeds and loan loss allowance; (xiv) the ability to finalize forward sale commitments; (xv) the ability to deliver loans in accordance with the terms of forward sale commitments; (xvi) the assumptions underlying the company s risk management practices; (xvii) the ability of the company s servicing platform to maintain high performance standards; (xviii) the satisfaction of the RBC transaction s closing conditions; and (xix) the approval of applicable government authorities and regulators of the RBC transaction. Additional information on these and other factors is contained in the company s Annual Report on Form 10-K for the year ended December 31, 2004, the company s Quarterly Report on Form 10-Q for the period ended March 31, 2005 and the company s other periodic filings with the Securities and Exchange Commission.

The company assumes no obligation to update the forward-looking statements contained in this Form 10-Q.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

June 30, 2005 and December 31, 2004

(Dollars in thousands, except share amounts)

	June 30, 2005 (unaudited)	December 31, 2004
Assets		
Cash and cash equivalents	$ 569,153	842,854
Restricted cash	736,259	454,035
Mortgage loans held for sale, net of reserves of $11,792 and $9,575, respectively	5,989,211	3,922,865
Mortgage loans held for investment, net of reserves of $145,565 and $90,227, respectively	18,482,990	13,195,324
Residual interests in securitizations	145,563	148,021
Mortgage servicing assets	40,395	8,249
Accrued interest receivable	108,350	66,208
Income taxes, net	93,122	180,840
Office property and equipment, net	72,774	47,266
Prepaid expenses and other assets	194,163	186,282
Total assets	$ 26,431,980	19,051,944
Liabilities and Stockholders Equity		
Credit facilities on mortgage loans held for sale	$ 5,627,207	3,704,268
Financing on mortgage loans held for investment, net	18,343,545	13,105,973
Accounts payable and accrued liabilities	411,351	320,108
Convertible senior notes, net	4,919	5,392
Notes payable	43,904	37,638
Total liabilities	24,430,926	17,173,379
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.01 par value, Authorized 10,000,000 shares; issued and outstanding 4,500,000 and zero shares at June 30, 2005 and December 31, 2004, respectively	45	
Common stock, $0.01 par value, Authorized 300,000,000 shares; issued and outstanding 56,179,685 and 54,702,623 shares at June 30, 2005 and December 31, 2004, respectively	562	547
Additional paid-in capital	1,254,763	1,108,590
Accumulated other comprehensive loss	(20,668)	(4,700)
Retained earnings, restricted	784,889	781,627

	2,019,591	1,886,064
Deferred compensation costs	(18,537)	(7,499)
Total stockholders equity	2,001,054	1,878,565
Total liabilities and stockholders equity	$ 26,431,980	19,051,944

See accompanying notes to unaudited condensed consolidated financial statements.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Earnings

(Dollars in thousands, except per share and share data)

(Unaudited)

	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Interest income	$ 420,861	191,135	751,932	344,263
Interest expense	(218,555)	(67,306)	(380,636)	(123,270)
Net interest income	202,306	123,829	371,296	220,993
Provision for losses on mortgage loans held for investment	(36,875)	(17,112)	(67,113)	(36,981)
Net interest income after provision for losses	165,431	106,717	304,183	184,012
Other operating income:				
Gain on sale of mortgage loans	138,704	215,051	278,456	417,027
Servicing income	6,631	7,753	13,353	13,649
Other income	3,398	829	7,271	829
Total other operating income	148,733	223,633	299,080	431,505
Operating expenses:				
Personnel	148,061	109,000	276,583	189,966
General and administrative	42,324	34,551	84,099	64,383
Advertising and promotion	20,711	15,684	40,543	29,249
Professional services	9,677	8,729	17,483	13,066
Total operating expenses	220,773	167,964	418,708	296,664
Earnings before income taxes	93,391	162,386	184,555	318,853
Income tax (benefit) expense	(1,688)	60,009	4,716	129,231
Net earnings	95,079	102,377	179,839	189,622
Dividends on preferred stock	285		285	
Net earnings available to common stockholders	$ 94,794	$ 102,377	179,554	189,622

Basic earnings per share	$ 1.71	3.07	3.26	5.72
Diluted earnings per share	$ 1.65	2.46	3.13	4.56
Basic weighted average shares outstanding	55,376,001	33,299,104	55,079,377	33,129,024
Diluted weighted average shares outstanding	57,396,098	42,161,644	57,331,721	42,088,799

See accompanying notes to unaudited condensed consolidated financial statements.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2005	**2004**	**2005**	**2004**
Net earnings	$ 95,079	102,377	179,839	189,622
Other comprehensive income (loss):				
Unrealized gain (loss) on derivative instruments designated as hedges, net of taxes of ($1.5) million, and $849,000 for the three and six months ended June 30, 2005, respectively, and $21.3 million, and $12.4 million for the three and six months ended June 30, 2004, respectively, net	(91,805)	30,585	(15,968)	18,333
Comprehensive income	$ 3,274	132,962	163,871	207,955

See accompanying notes to unaudited condensed consolidated financial statements.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Changes in Stockholders Equity

Six Months Ended June 30, 2005

(In thousands, except per share amounts)

	Preferred shares outstanding	Preferred stock amount	Common shares outstanding	Common stock amount	Additional paid-in capital	Accumulated Other Comprehensive Loss	Retained earnings, restricted	Deferred compensation	Total
Balance December 31, 2004			54,703	547	1,108,590	(4,700)	781,627	(7,499)	1,878,565
Proceeds from issuance of common stock			1,381	14	16,919				16,933
Proceeds from issuance of preferred stock	4,500	45			108,911				108,956
Cancelled shares related to stock options			(224)	(2)	(9,584)				(9,586)
Conversion of convertible senior notes			15		500				500
Issuance of restricted stock, net			305	3	14,833			(14,836)	
Amortization of deferred compensation								3,798	3,798
Net earnings							179,839		179,839
Tax benefit related to non-qualified stock options					14,594				14,594
Other comprehensive loss, net of tax						(15,968)			(15,968)
Dividends declared on common stock, $3.15 per share							(176,292)		(176,292)
Dividends on preferred stock, $0.06 per share							(285)		(285)
	4,500	$ 45	56,180	$ 562	1,254,763	(20,668)	784,889	(18,537)	2,001,054

Balance June 30, 2005 (unaudited)	

See accompanying notes to unaudited condensed consolidated financial statements.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(Dollars in thousands)

(Unaudited)

	Six Months Ended	
	June 30, 2005	June 30, 2004
Cash flows from operating activities:		
Net earnings	$ 179,839	189,622
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	57,311	12,105
Cash flows received from residual interests	12,210	27,537
Accretion of Net Interest Receivables, or NIR	(7,927)	(9,358)
NIR gains	1,670	(21,871)
Initial deposits to over-collateralization accounts	(7,914)	(10,871)
Retained bond		(3,536)
Servicing gains	(35,893)	
Fair value adjustment of residual securities	4,419	6,770
Provision for losses on mortgage loans held for investment	67,113	36,981
Provision for repurchase losses	6,072	3,184
Mortgage loans originated or acquired for sale	(15,587,599)	(17,234,447)
Mortgage loan sales, net	13,520,803	14,140,969
Principal payments on mortgage loans held for sale	115,017	55,709
Increase in credit facilities on mortgage loans held for sale	1,922,939	2,808,168
Tax benefit related to non-qualified stock options	14,594	
Net change in other assets and liabilities	14,765	51,217
Net cash provided by operating activities	277,419	52,179
Cash flows from investing activities:		
Mortgage loans originated or acquired for investment, net	(8,174,316)	(3,457,776)
Principal payments on mortgage loans held for investment	2,759,900	739,313
Purchases of office property and equipment	(35,618)	(12,594)
Net cash used in investing activities	(5,450,034)	(2,731,057)
Cash flows from financing activities:		
Proceeds from issuance of financing on mortgage loans held for investment, net	8,574,456	5,017,915
Repayments of financing on mortgage loans held for investment	(2,588,407)	(640,625)

Decrease in credit facilities on mortgage loans held for investment	(756,835)	(1,680,487)
Proceeds from issuance of preferred stock	108,956	
Proceeds from notes payable	15,726	17,756
Repayment of notes payable	(9,460)	(6,248)
Change in restricted cash	(282,224)	(205,486)
Payment of dividends on common stock	(168,938)	(12,132)
Net proceeds from issuance of stock	17,433	4,527
Purchase of treasury stock	(11,793)	
Net cash provided by financing activities	4,898,914	2,495,220
Net decrease in cash and cash equivalents	(273,701)	(183,658)
Cash and cash equivalents, beginning of period	842,854	278,598
Cash and cash equivalents, end of period	$ 569,153	94,940
Supplemental cash flow disclosure:		
Interest paid	$ 372,065	113,913
Income taxes paid	83,223	157,892
Supplemental non-cash financing activity:		
Restricted stock issued	$ 17,966	$ 5,782
Accrued dividends	90,176	6,781

See accompanying notes to unaudited condensed consolidated financial statements.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

June 30, 2005 and 2004

1. Basis of Presentation

New Century TRS Holdings, Inc. (formerly known as New Century Financial Corporation), a Delaware corporation (New Century TRS), was incorporated on November 17, 1995. New Century Mortgage Corporation, a wholly-owned subsidiary of New Century TRS (New Century Mortgage), commenced operations in February 1996 and is a mortgage finance company engaged in the business of originating, purchasing, selling and servicing mortgage loans secured primarily by first and second mortgages on single-family residences. NC Capital Corporation, a wholly-owned subsidiary of New Century Mortgage (NC Capital), was formed in December 1998 to conduct the secondary marketing activities of New Century (as defined below). New Century Credit Corporation (formerly known as Worth Funding Incorporated) (New Century Credit), a wholly-owned subsidiary of New Century, was acquired in March 2000 by New Century Mortgage. NC Residual IV Corporation (NCRIV), a wholly-owned subsidiary of New Century, was formed in September 2004 to hold a portfolio of mortgage loans held for investment. After consummation of the Merger (defined below), New Century purchased New Century Credit from New Century Mortgage. The terms New Century, Company, we, our, and us refer to New Century Financial Corporation, except where the context otherwise requires.

On April 5, 2004, New Century TRS s board of directors approved a plan to change New Century TRS s capital structure to enable it to qualify as a real estate investment trust, or REIT, for United States federal income tax purposes. The decision to convert to a REIT was based on several factors, including the potential for increased stockholder return, tax efficiency and ability to achieve growth objectives. On April 19, 2004, New Century TRS s board of directors approved certain legal and financial matters related to the proposed REIT conversion.

On April 12, 2004, New Century TRS formed New Century Financial Corporation (formerly known as New Century REIT, Inc.), a Maryland corporation (New Century). On September 15, 2004, New Century TRS s stockholders approved and adopted the Agreement and Plan of Merger dated as of April 21, 2004 (the Merger Agreement), by and among New Century TRS, New Century and NC Merger Sub, Inc., a Delaware corporation formed by New Century for purposes of effecting the Merger (Merger Sub), which implemented the restructuring of New Century TRS in order for it to qualify as a REIT (the Merger).

Pursuant to the Merger Agreement, (i) Merger Sub merged with and into New Century TRS, with New Century TRS as the surviving corporation, (ii) each outstanding share of New Century TRS s common stock was converted into the right to receive one share of common stock, par value of $0.01 per share, of New Century, (iii) New Century TRS became a wholly-owned subsidiary of New Century and changed its name from New Century Financial Corporation to New Century TRS Holdings, Inc., and (iv) New Century REIT, Inc. changed its name to New Century Financial Corporation. The Merger was consummated and became effective on October 1, 2004, and was accounted for on an as if pooling basis. These condensed consolidated financial statements give retroactive effect to the Merger for the periods presented. Accordingly, under as if pooling accounting, the assets and liabilities of New Century TRS transferred to New Century in connection with the Merger have been accounted for at historical amounts as if New Century TRS was transferred to New Century as of the earliest date presented and the condensed consolidated financial statements of New Century prior to the Merger include the results of operations of New Century TRS. Stockholders equity amounts presented for years prior to the formation of New Century are those of New Century TRS, adjusted for the Merger exchange rate.

On September 29, 2004, in contemplation of the Merger, New Century TRS requested that The Nasdaq Stock Market, Inc. suspend the listing of the shares of New Century TRS s common stock on the Nasdaq National Market prior to the commencement of trading on October 1, 2004. Shares of New Century s common stock, which were issued in exchange for then outstanding shares of New Century TRS s common stock on a one-for-one basis in connection with the Merger, were approved for listing on the New York Stock Exchange, Inc. and commenced trading on October 1, 2004 under the ticker symbol NEW.

The accompanying condensed consolidated financial statements include the consolidated financial statements of the Company s wholly-owned subsidiaries, New Century TRS, New Century Credit, and NCRIV. All material intercompany balances and transactions are eliminated in consolidation. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America.

The Company has prepared the accompanying unaudited condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

June 30, 2005 and 2004

accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the consolidated financial statements and notes thereto included in New Century s Annual Report on Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission.

Reclassification

Certain amounts from prior year s presentation have been reclassified to conform to the current year s presentation.

Recent Accounting Developments

In May 2003, the FASB issued FAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. FAS 150 establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. FAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 except for mandatory redeemable financial instruments of nonpublic entities. The Company applied the provisions of FAS 150 when the Series A Cumulative Redeemable Preferred Stock was issued in the second quarter of 2005.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R, Share-based Payment, or SFAS 123R. SFAS 123R is a revision of FASB Statement No. 123, Accounting for Stock-based Compensation, and supercedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires an entity to measure the cost of employee services in exchange for an award of equity instruments based on the grant date fair value of the award (with limited exception). That cost will be recognized over the period during which the employee is required to provide service in exchange for the award, or the requisite service period, which is usually the vesting period. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Employee share purchase plans will not result in recognition of compensation expense if certain conditions are met.

The notes to financial statements will disclose information to assist users of financial information to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements. In April 2005, the Securities and Exchange Commission deferred the effective date of SFAS 123R. The Company will be required to apply the provisions of SFAS 123R beginning in 2006. There are three methods from which an entity may select to apply the provisions of SFAS 123R during the transition period: modified prospective application, modified retrospective application all periods, and modified retrospective application interim periods. The Company provides pro forma disclosure as to the impact of SFAS 123 or 123R in footnote 1 of the Notes to Condensed Consolidated Financial Statements Stock-Based Compensation.

Cash and Cash Equivalents

For purposes of the statements of cash flows, the Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. Cash equivalents consist of cash on hand and due from banks.

Restricted Cash

As of June 30, 2005, restricted cash totaled $736.3 million, and included $116.5 million in cash held in a margin account associated with the Company s interest rate risk management activities, $599.8 million in cash held in custodial accounts associated with its mortgage loans held for investment, and $20.0 million in cash held in a cash reserve account in connection with its asset-backed commercial paper facility. As of December 31, 2004, restricted cash totaled $454.0 million, and included $58.2 million in cash held in a margin account associated with its interest rate risk management activities, $375.8 million in cash held in custodial accounts associated with its mortgage loans held for investment, and $20.0 million in cash held in a cash reserve account in connection with its asset-backed commercial paper facility.

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NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

June 30, 2005 and 2004

Mortgage Loans Held for Sale

Mortgage loans held for sale are stated at the lower of amortized cost or fair value as determined by outstanding commitments from investors or current investor-yield requirements, calculated on an aggregate basis.

Mortgage Loans Held for Investment

Mortgage loans held for investment represent loans securitized through transactions structured as financings, or pending securitization through transactions that are expected to be structured as financings. Mortgage loans held for investment are stated at amortized cost, including the outstanding principal balance, less the allowance for loan losses, plus net deferred origination costs. The financing related to these securitizations is included in the Company s condensed consolidated balance sheet as financing on mortgage loans held for investment.

Allowance for Losses on Mortgage Loans Held for Investment

In connection with its mortgage loans held for investment, the Company establishes an allowance for loan losses based on its estimate of losses inherent and probable as of its balance sheet date. The Company charges off uncollectible loans at the time of liquidation. The Company evaluates the adequacy of this allowance each quarter, giving consideration to factors such as the current performance of the loans, characteristics of the portfolio, the value of the underlying collateral and the general economic environment. In order to estimate an appropriate allowance for losses for loans held for investment, the Company estimates losses using static pooling, which stratifies the loans held for investment into separately identified vintage pools. Provision for losses is charged to the Company s condensed consolidated statement of earnings. Losses incurred are charged to the allowance. Management considers the current allowance to be adequate.

Residual Interests in Securitizations

Residual interests in securitizations, or Residuals, are recorded as a result of the sale of loans through securitizations that the Company structures as sales rather than financings, referred to as off-balance sheet securitizations. The Company may also sell Residuals through what are sometimes referred to as net interest margin securities, or NIMS.

In a securitization structured as a sale, the Company sells a pool of loans to a trust for a cash purchase price and a certificate evidencing its 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. The Company receives the cash flows from the Residuals 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 the Company 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 rate on the certificates. Accordingly, the Residuals described above are a significant asset of the Company. In determining the value of the Residuals, the Company estimates the future rate of prepayments, prepayment penalties that it will receive, delinquencies, defaults and default loss severity as they affect the amount and timing of the estimated cash flows. The Company estimates average cumulative losses as a percentage of the original principal balance of the mortgage loans of 1.65% to 4.62% for adjustable-rate securities and 1.44% to 5.13% for fixed-rate securities. The Company bases 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 3.75% at June 30, 2005. The Company estimates prepayments by evaluating historical prepayment performance of its loans and the impact of current trends. The Company uses 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 2.28 to 2.57 years for the Company s adjustable-rate securities and 2.44 to 3.49 years for its fixed-rate securities.

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During the quarter ended June 30, 2005, the Company completed a $989.2 million securitization structured as a sale resulting in a gain on sale of $21.2 million. In addition, the Company s retained interest was $6.2 million.

During the six months ended June 30, 2005, the Residuals provided $12.2 million in net cash flow to the Company. The Company performs an evaluation of the Residuals quarterly, taking into consideration trends in actual cash flow performance, industry and economic developments, as well as other relevant factors. During the quarter ended June 30, 2005, the Company increased its prepayment rate assumptions based upon actual performance and made minor adjustments to certain other assumptions, resulting in a $3.1 million decrease in the fair value for the quarter and is recorded as a reduction to gain on sale of mortgage loans.

The bond and certificate holders and their securitization trusts have no recourse to the Company for failure of mortgage loan borrowers to pay when due. The Company s Residuals are subordinate to the bonds and certificates until the bond and certificate holders are fully paid.

The Company is party to various transactions that have an off-balance sheet component. In connection with the Company s off-balance sheet securitization transactions, as of June 30, 2005, there were $1.8 billion in loans owned by the off-balance sheet trusts. The trusts have issued bonds secured by these loans. The bondholders generally do not have recourse to the Company in the event that the loans in the various trusts do not perform as expected. Because these trusts are qualifying special purpose entities, in accordance with generally accepted accounting principles, the Company has included only its residual interest in these loans on its condensed consolidated balance sheet. The performance of the loans in the trusts will impact the Company s ability to realize the current estimated fair value of these residual assets.

Derivative Instruments Designated as Hedges

The Company accounts for certain Euro Dollar futures and interest rate cap contracts designated and documented as cash flow hedges pursuant to the requirements of Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). Pursuant to SFAS 133, these contracts have been designated as hedging the exposure to variability of cash flows from the Company s variable rate 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 hedge be reported in other comprehensive income and the ineffective portion be reported in current earnings. Additionally, certain Euro Dollar futures contracts were 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.

Income Taxes

The Company is a REIT for federal income tax purposes and is not generally required to pay federal and most state income taxes if it meets the REIT requirements of the Internal Revenue Code of 1986, as amended, or the Code. Also, the Company s 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, the Company must recognize income taxes in accordance with Statement of Financial Accounting Standards No. 109 Accounting for Income Taxes, (SFAS 109) for its taxable REIT subsidiaries, or TRS, whose income is fully taxable at regular corporate rates.

SFAS 109 requires that inter-period income tax allocation be based on the asset and liability method. Accordingly, the Company recognizes the tax effects of temporary differences between its tax and financial reporting bases of assets and liabilities that will result in taxable or deductible amounts in future periods.

Stock-Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations, in accounting for employee stock options rather than the fair value accounting allowed by

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(Unaudited)

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Financial Accounting Standards Board (FASB) Statement No. 123, Accounting for Stock-Based Compensation (SFAS 123). APB 25 provides that compensation expense relative to the Company s employee stock options is recorded over the vesting period if the current market price of the underlying stock exceeds the exercise price on the date of grant. Under SFAS 123, the fair value of stock options at the date of grant is recognized in earnings over the vesting period of the options. In December 2002, FASB issued Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), which amends SFAS 123 to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method on reported results.

The fair value of each stock option granted is estimated at the date of grant using the Black-Scholes option-pricing model. The weighted average fair value of stock options granted and the weighted average underlying assumptions used to estimate those values for the three and six months ended June 30, 2005 and 2004 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Fair value	$ 8.98	$ 22.27	$ 9.21	$ 19.06
Expected life (years)	4.5	4.5	4.5	4.5
Risk-free interest rate	3.8%	3.8%	4.2%	3.3%
Volatility	60.0%	60.6%	60.5%	52.2%
Expected annual dividend yield	13.78%	1.80%	13.68%	1.76%

As of June 30, 2005 and 2004, there were stock options outstanding for the purchase of 4,394,552 and 5,495,015 shares, respectively, of the Company s common stock. The following table shows the pro forma net income as if the fair value method of SFAS 123 had been used to account for stock-based compensation expense (dollars in thousands, except per share amounts):

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	**2004**	**2005**	**2004**
Basic net earnings available to common shareholders:				
As reported	$ 94,794	102,377	179,554	189,622
Compensation expense, net of related tax effects	(1,664)	(1,325)	(3,189)	(2,505)
Pro forma	$ 93,130	101,052	176,365	187,117
Diluted net earnings available to common shareholders:				
As reported	$ 94,871	103,631	179,649	192,129
Compensation expense, net of related tax effects	(1,664)	(1,325)	(3,189)	(2,505)
Pro forma	$ 93,207	102,306	176,460	189,624
Basic earnings per share:				
As reported	$ 1.71	3.07	3.26	5.72
Pro forma	1.68	3.03	3.20	5.65
Diluted earnings per share:				
As reported	$ 1.65	2.46	3.13	4.56
Pro forma	1.64	2.47	3.11	4.59
Basic weighted average shares outstanding:				
As reported	55,376	33,299	55,079	33,129
Pro forma	55,376	33,299	55,079	33,129
Diluted weighted average shares outstanding:				
As reported	57,396	42,162	57,332	42,089
Pro forma	56,684	41,397	56,665	41,319

2. Mortgage Loans Held for Sale

A summary of mortgage loans held for sale, at the lower of cost or market at June 30, 2005 and December 31, 2004, is as follows (dollars in thousands):

	June 30, 2005	December 31, 2004
First trust deeds	$ 5,370,148	3,686,830
Second trust deeds	586,463	197,362
Net deferred origination costs and other	32,600	38,673
	$ 5,989,211	3,922,865

At June 30, 2005, the Company had mortgage loans held for sale of approximately $31.3 million on which the accrual of interest had been discontinued. If these mortgage loans had been current throughout their terms, interest income would have increased by approximately $1.2 million for the six months ended June 30, 2005.

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3. Mortgage Loans Held for Investment

For the three and six months ended June 30, 2005, the Company securitized $5.9 billion and $8.9 billion in loans, respectively, through transactions structured as financings, resulting in an increase in its mortgage loans held for investment. As of June 30, 2005, the balance of mortgage loans held for investment included $25.7 million of mortgage loans held for investment that were not yet securitized. A summary of the components of mortgage loans held for investment at June 30, 2005 and December 31, 2004 is as follows (dollars in thousands):

	June 30, 2005	December 31, 2004
Mortgage loans held for investment:		
Unpaid principal balance of mortgage loans	$ 18,475,484	13,169,595
Allowance for loan losses	(145,565)	(90,227)
Net deferred origination costs	153,071	115,956
	$ 18,482,990	13,195,324

At June 30, 2005, the Company had mortgage loans held for investment of approximately $319.5 million on which the accrual of interest had been discontinued. If these mortgage loans had been current throughout their terms, interest income would have increased by approximately $13.6 million for the six months ended June 30, 2005.

The following table presents a summary of the activity for the allowance for losses on mortgage loans held for investment for the three and six months ended June 30, 2005 and 2004 (dollars in thousands):

	Three Months Ended June 30,	Six Months Ended June 30,

	2005	2004	2005	2004
Beginning balance	$ 117,495	45,596	90,227	26,251
Additions	36,875	17,112	67,113	36,981
Charge-offs	(8,805)	(1,401)	(11,775)	(1,925)
	$ 145,565	61,307	145,565	61,307

4. Residual Interests in Securitizations

Residual interests in securitizations consisted of the following components at June 30, 2005 and December 31, 2004 (dollars in thousands):

	June 30, 2005	December 31, 2004
Over-collateralization account	$ 158,621	158,755
Net interest receivable (NIR)	(13,058)	(10,734)
	$ 145,563	148,021

The net interest receivable, or NIR, balance above represents the discounted value of cash flows expected to be received from net interest spread, while the over-collateralization account represents the current, un-discounted balance of over-collateralization as of the period end. Residual interests in securitizations are recorded at estimated fair value, which is based on estimated discounted cash flows, resulting in the presentation above.

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The following table summarizes the activity in the over-collateralization, or OC, accounts for the six months ended June 30, 2005 and 2004 (dollars in thousands):

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Balance, beginning of period	$ 158,755	169,905
Initial deposits to OC accounts	7,914	
Additional deposits to OC accounts	1,305	10,871
Release of cash from OC accounts	(9,353)	(8,167)
Balance, end of period	$ 158,621	172,609

The following table summarizes activity in the NIR accounts for the six months ended June 30, 2005 and 2004 (dollars in thousands):

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Balance, beginning of period	$ (10,734)	9,593
NIR gains	(1,670)	21,871
Cash received from NIRs	(4,162)	(19,370)
Accretion of NIRs	7,927	9,358
Fair value adjustment	(4,419)	(6,770)
Balance, end of period	$ (13,058)	14,682

During the six months ended June 30, 2005, the Company completed a $989.2 million securitization structured as a sale. During the six months ended June 30, 2004, the Company completed a $337.1 million securitization structured as a sale, related to its investment in Carrington Mortgage Credit Fund I, LP, (Carrington). Purchasers of securitization bonds and certificates have no recourse against the other assets of the Company, other than the assets of the trust. The value of the Company s retained interests is subject to credit, prepayment and interest rate risk on the transferred financial assets.

5. Mortgage Servicing Assets

Mortgage servicing assets represent the carrying value of our mortgage loan servicing rights. The following table summarizes activity in the mortgage servicing assets for the six months ended June 30, 2005 and 2004 (dollars in thousands):

	Six Months Ended June 30,	
	2005	**2004**
Balance, beginning of period	$ 8,249	1,900
Additions	35,893	
Amortization	(3,747)	(252)
Balance, end of period	$ 40,395	1,648

The Company records mortgage servicing assets when it sells loans on a servicing-retained basis and when it sells loans through whole loan sales to an investor in the current period and sells the servicing rights to a third party in a subsequent period.

The addition of $35.9 million for the six months ended June 30, 2005 includes (i) $27.2 million of servicing rights retained by the Company in certain of its whole loan sales to Carrington and (ii) $8.7 million of servicing rights related to the securitization structured as a sale completed in June 2005. The $8.7 million of servicing rights associated with the securitization structured as a sale was subsequently sold to a third party in August 2005 for $8.7 million. As of June 30, 2005, the Company had also retained the right to service $17.1 billion of loans underlying its portfolio of mortgage loans held for investment.

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6. Goodwill

Goodwill is recorded in connection with the acquisition of new subsidiaries and is included in prepaid expenses and other assets. As of June 30, 2005 and December 31, 2004, the Company had goodwill of $15.5 million. No impairment was recognized during the six months ended June 30, 2005.

7. Credit Facilities and Other Short-Term Borrowings

Credit facilities and other short-term borrowings consist of the following at June 30, 2005 and December 31, 2004 (dollars in thousands):

	June 30, 2005	December 31, 2004
A $2.0 billion asset-backed commercial paper facility for Von Karman Funding LLC, a wholly-owned subsidiary of New Century Mortgage, expiring in September 2006, secured by mortgage loans held for sale and cash generated through the sale of loans, bearing interest based on a margin over one-month LIBOR.	$	
A $2.0 billion master repurchase agreement ($1 billion of which is uncommitted) between New Century Funding A, a Delaware business trust which is a wholly-owned subsidiary of New Century Mortgage, and Bank of America, N.A., expiring in August 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.	769,730	975,119
A $1.0 billion master repurchase agreement among New Century Credit, NC Residual II Corporation, a wholly-owned subsidiary of NC Capital (NC Residual II), New Century Mortgage, NC Capital and Barclays Bank PLC expiring in November 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.	609,719	43,917
An $800 million aggregation facility ($400 million of which is uncommitted) from Bear Stearns Mortgage Capital expiring in October 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.	764,471	428,397

A $700 million master repurchase agreement among New Century Credit, New Century Mortgage, NC Capital, NC Residual II, and IXIS Real Estate Capital Inc. expiring in September 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.	428,626	617,141
A $150 million master repurchase agreement between New Century Funding SB-1, a Delaware business trust and wholly-owned subsidiary of New Century Mortgage, and Citigroup Global Markets, successor to Salomon Brothers, expiring in September 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.		

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	June 30, 2005	December 31, 2004
A $650 million repurchase agreement among New Century Credit, NC Capital and Citigroup Global Markets Reality Corp., successor to Salomon Brothers, expiring in September 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. We have the ability to increase the size of this facility to $800 million provided that the value of the loans outstanding at any one time under this facility and the $150 million facility set forth immediately above may not exceed $800 million in the aggregate. The Company expects to either renew or extend this facility prior to its expiration.	668,459	260,025
A $150 million master loan and security agreement among New Century Mortgage, NC Capital, New Century Financial and Citigroup Global Markets Realty Corp., successor to Salomon Brothers Realty Corp., expiring in December 2005, secured by delinquent loans and REO properties, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.	1,091	959
A $250 million repurchase agreement between New Century Mortgage and Citigroup Global Markets, which expires in December 2005, secured by small balance commercial mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	25,529	54,398
A $500 million master loan and security agreement among New Century Credit, New Century Mortgage, NC Capital and Credit Suisse First Boston Mortgage Capital LLC expiring in November 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. The Company expects to either renew or extend this facility prior to its expiration.	352,785	
A $2.0 billion master loan and security agreement among New Century Credit, New Century Mortgage, NC Capital, NC Residual II, Morgan Stanley Bank, Concord Minutemen Capital Company, LLC and Morgan Stanley Mortgage Capital Inc. expiring in February 2007, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	705,874	959,822
A $2.0 billion asset-backed note purchase and security agreement ($500 million, of which is uncommitted) between New Century Funding I, a special-purpose vehicle established as a Delaware statutory trust, which is a wholly-owned subsidiary of New Century Mortgage, and UBS Real Estate Securities Inc., expiring in June 2006, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	1,320,764	1,141,167
Less: Credit facility amounts reclassified to financing on mortgage loans held for investment	(19,841)	(776,677)
	$ 5,627,207	3,704,268

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The various credit facilities contain certain restrictive financial and other covenants that require the Company to, among other things, restrict dividends, maintain certain levels of net worth, liquidity, available borrowing capacity, and debt-to-net worth ratios and to comply with regulatory and investor requirements. The Company was in compliance with these covenants at June 30, 2005.

8. Financing on Mortgage Loans Held for Investment

When the Company sells loans through securitizations structured as financings, the related bonds are added to its balance sheet. As of June 30, 2005 and December 31, 2004, the financing on mortgage loans held for investment consisted of the following (dollars in thousands):

	June 30, 2005	December 31, 2004
Securitized bonds	$ 18,378,752	12,379,524
Short-term financing on retained bonds	9,945	23,616
2003-NC5 NIM bond		7,583
2005-NC3 NIM bond	8,272	
Debt issuance costs	(73,265)	(81,427)
Credit facility amounts reclassified from warehouse credit facilities	19,841	776,677
Total financing on mortgage loans held for investment	$ 18,343,545	13,105,973

The Company s maturity of financing on mortgage loans held for investment is based on certain prepayment assumptions. The Company estimates the average life to be between 1.9 and 4.0 years. The following table reflects the estimated maturity of the financing on mortgage loans held for investment as of June 30, 2005 (dollars in thousands):

Due in less than 1 year	$ 4,850,728
Due in 2 years	5,587,436

Due in 3 years	2,410,775
Thereafter	5,494,606
	$ 18,343,545

9. Convertible Senior Notes Private Offering

On July 8, 2003, New Century TRS closed a private offering of $175.0 million of convertible senior notes due July 3, 2008 pursuant to Rule 144A under the Securities Act of 1933. On July 14, 2003, the initial purchasers of the convertible senior notes exercised their option, in full, to acquire an additional $35.0 million principal amount of the convertible senior notes. The convertible senior notes bear interest at a rate of 3.50% per year, paid semi-annually, and, as of March 17, 2004, became convertible into New Century TRS common stock at a conversion price of $34.80 per share. The conversion price represents a 28.0% premium over the closing share price on July 8, 2003. Principal balance is not due until maturity. As a result of the Merger, the convertible senior notes became convertible into shares of New Century common stock. On February 14, 2005, New Century, New Century TRS and the trustee under the indenture governing the convertible senior notes entered into a second supplemental indenture pursuant to which New Century agreed to fully and unconditionally guarantee the due and punctual payment of the convertible senior notes.

On November 22, 2004, New Century TRS commenced an offer, upon the terms and subject to the conditions described in the prospectus related to the offer and the accompanying letter of transmittal, to convert all the outstanding convertible senior notes into shares of New Century common stock, cash, or a combination of both. The offer and withdrawal rights expired at midnight, New York City time, on December 23, 2004. On December 24, 2004, New Century TRS accepted for payment $204.5 million, or approximately 97.4%, of the $210.0 million aggregate principal amount of the convertible senior notes then outstanding, which constituted all of the convertible senior notes validly tendered and not withdrawn. In the aggregate, the holders who tendered their convertible senior notes for conversion in the offer received 6,236,431 shares of New Century common stock, which included 359,796 shares for additional consideration and an additional $3.4 million in cash for accrued interest through that date. On June 27, 2005, a holder of New Century TRS

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convertible senior notes proposed, and it agreed, to convert $500,000 principal amount of convertible senior notes into 15,014 shares of its common stock. In connection with the conversion, the Company made a cash payment to the holder of $51,104, which included a conversion incentive fee and accrued interest through that date.

As of June 30, 2005, the number of shares of the Company s common stock into which the remaining convertible senior notes were convertible into was 150,143, subject to certain adjustments under the terms of the convertible senior notes. For example, the terms of the convertible senior notes allow for the bondholder s conversion rate to adjust if the Company s dividend rate increases generally above a dividend yield of 1.75%, subject to certain other factors. As of June 30, 2005, the maximum number of shares of the Company s common stock into which the remaining untendered convertible senior notes were convertible into was 176,637, subject to certain adjustments under the terms of the convertible senior notes. On July 29, 2005, concurrent with the payment of a cash dividend of $1.60 per share, the number of shares into which the remaining convertible senior notes were convertible was adjusted to 154,679.

10. Series A Cumulative Redeemable Preferred Stock Offering

In June 2005, the Company sold 4,500,000 shares, which included 300,000 shares sold to the underwriters to cover overallotments, of its Series A Cumulative Redeemable Preferred Stock, raising $109.0 million in net proceeds. The shares have a liquidation value of $25.00 per share and pay an annual coupon of 9.125% and are not convertible into any other securities. The Company may, at its option, redeem the Series A Cumulative Redeemable Preferred Stock, in the aggregate or in part, at any time on or after June 21, 2010. As such, this stock is not considered mandatorily or contingently redeemable under the provisions of SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* and is therefore classified as a component of equity. Accrued preferred stock dividends were $285,000 as of June 30, 2005.

11. Interest Income

The following table presents the components of interest income for the three and six months ended June 30, 2005 and 2004 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Interest on mortgage loans held for investment	$ 315,887	97,472	563,547	176,809
Interest on mortgage loans held for sale	98,830	89,071	175,029	158,063
Residual interest income	3,903	4,578	7,927	9,358
Other interest income	2,241	14	5,429	33
	$ 420,861	191,135	751,932	344,263

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12. Interest Expense

The following table presents the components of interest expense for the three and six months ended June 30, 2005 and 2004 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Interest on financing on mortgage loans held for investment	$ 160,646	33,430	278,366	66,415
Interest on credit facilities and other short-term borrowings	54,850	29,743	97,056	49,686
Interest on convertible senior notes	60	2,126	123	4,250
Other interest expense	2,999	2,007	5,091	2,919
	$ 218,555	67,306	380,636	123,270

13. Hedging Activities

In connection with the Company s strategy to mitigate interest rate risk on its residual assets, mortgage loans held for sale and mortgage loans held for investment, the Company uses derivative financial instruments such as Euro Dollar futures and interest rate cap contracts. It is not the Company s policy to use derivatives to speculate on interest rates. These derivative instruments have an active secondary market, and are intended to provide income and cash flow to offset potential reduced interest income and cash flow under certain interest rate environments, as well as to hedge the fair value of certain fixed-rate mortgage loans held for investment and certain mortgage loans held for sale. In accordance with SFAS 133, the derivative financial instruments and any related margin accounts are reported on the condensed consolidated balance sheets at their fair value.

In 2003, the Company began applying hedge accounting as defined by SFAS 133 for certain deriv